**CITICORP VENTURE CAPITAL, LTD., a New York Corporation, Appellant No. 02-1815 v. COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION; CITICORP VENTURE CAPITAL, LTD., a New York Corporation, v. COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION, Appellant No. 02-1905**

**Nos. 02-1815, 02-1905**

**UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT**

***323 F.3d 228; 2003 U.S. App. LEXIS 4939; 41 Bankr. Ct. Dec. 6***

**December 16, 2002, Argued**

**March 19, 2003, Filed**

**COUNSEL:**

Lawrence J. Slattery, Esq. (Argued), Morgan, Lewis & Bockius, New York, NY. Amy M. Tonti, Esq., Reed Smith, Pittsburgh, PA, Counsel for Appellant/Cross Appellee.

Philip E. Beard, Esq., Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, PA. Stephen M. Ray, Esq. (Argued), Stutman, Treister & Glatt, Los Angeles, CA, Counsel for Appellee/Cross Appellant.

**JUDGES:**

BEFORE: NYGAARD, ALITO, and RENDELL, Circuit Judges.

**OPINION BY:**

NYGAARD

**OPINION:**

**OPINION OF THE COURT**

NYGAARD, *Circuit Judge*:

This case arises out of the Chapter 11 filing of Papercraft Corporation and the subsequent litigation. Here, in our second review of determinations made by the Bankruptcy Court and the District Court, we must assess justifications for the subordination of several of Citicorp Venture Capital's ("CVC") claims, and we must evaluate the accompanying calculations. First, CVC argues that the District Court erroneously upheld the Bankruptcy Court's subordination of certain administrative costs and professional fees. Second, CVC contends that the District Court erroneously upheld the Bankruptcy Court's subordination of CVC's claim by an additional amount incurred during a delay in the plan process. Third, CVC asserts that the finding that CVC made a profit on its note purchases is error. Finally, in a cross appeal, the Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation (the "Committee") argues that the District Court erred in reducing the Bankruptcy Court's equitable subordination remedy on account of lost interest income. We hold that the "American Rule" should not be applied to the subordination of the administrative and professional costs, and that the District Court's findings are not clearly erroneous. We will affirm.

I. Background

In 1991, an informal committee of Papercraft creditors and Papercraft agreed to a restructuring plan known as the "BDK plan," which was to be filed in conjunction with a

voluntary Chapter 11 petition. The creditors' claims against Papercraft would be converted into "BDK units," consisting of stock and bonds issued by the new venture, in proportion to an estimated value of such units. Papercraft's directors, including CVC, approved the BDK plan, and the Chapter 11 petition and the BDK plan were filed.

The Committee commenced litigation, alleging that CVC, while an insider and fiduciary of Papercraft, attempted to take control of Papercraft's assets and reap significant profit at the expense of other creditors by withdrawing its support for the BDK plan and offering a competing plan, secretly purchasing $60,849,299.10 in claims against Papercraft for the discounted amount of $10,553,541.88, and delaying confirmation of the original plan. The Committee asserted that because CVC breached its fiduciary duty to Papercraft and Papercraft's creditors by engaging in such self-dealing, CVC's claims should be equitably subordinated pursuant to *§ 510(c) of the Bankruptcy Code, 11 U.S.C. § 510(c).*

The Bankruptcy Court issued an October 12, 1995, Memorandum Opinion and Order, finding that CVC's purchases at a discount, without disclosure, while an insider, constituted breaches of CVC's fiduciary duty to Papercraft and its creditors. *In re Papercraft Corp., 187 B.R. 486, 498-99 (Bankr. W.D. Pa. 1995).* The Bankruptcy Court limited CVC's allowed claim to the $10,553,541.88 price, and held that further subordination of CVC's claims pursuant to the principles of equitable subordination codified at *11 U.S.C. § 510(c)* was not appropriate because the Bankruptcy Court was already limiting CVC's allowed claim to the amount it paid for such claim. *Id. at 501-02.*

On appeal, the District Court affirmed the Bankruptcy Court's factual findings that CVC breached its fiduciary duties, acted inequitably, caused injury to Papercraft and its creditors and gained an unfair advantage. *In re Papercraft Corp., 211 B.R. 813 (W. D. Pa. 1997).* However, the District

Court remanded the case to the Bankruptcy Court for a further finding on the amount CVC's claims should be subordinated beyond the amount paid for such claims, if at all, pursuant to the principles of equitable subordination. *Id. at 827*. Both parties appealed.

We affirmed the District Court's opinion, finding that CVC violated its fiduciary duty in a number of significant respects and that CVC's misconduct caused harm justifying subordination. *In re Papercraft Corp., 160 F.3d 982, 988-90 (3d Cir. 1998)*. We explicitly stated that the findings of fact "make this a paradigm of inequitable conduct by a fiduciary as that concept has been developed in the case law, and we believe that further elaboration is not required." *Id. at 987*. We explained that,

> Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles. . . . While the bankruptcy court held, with record support, that the delay between the filing of the petition and the filing of the disclosure statement was not attributable to CVC's machinations, it made no similar finding with respect to the period of delay between the filing of the disclosure statement and confirmation of the BDK plan. Moreover, while the bankruptcy court found "no evidence that CVC engaged in conduct designed to delay the plan process," if CVC's pursuit of its own interest in fact resulted in delay of the confirmation, we do not read that finding as inconsistent with subordination based on injury resulting from that delay. On remand, the bankruptcy court should consider whether the record supports the proposition that non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan.

*Id. at 991-92.* Our mandate to the Bankruptcy Court was clear: determine whether the record supports the additional subordination of CVC's claims.

On remand, the Bankruptcy Court found three kinds of economic harm to non-selling noteholder creditors: (1) the quantifiable monetary harm that resulted from the delay in confirming the plan; (2) the harm that resulted from the uncertainty over the amount of CVC's claim distribution; and (3) the harm that resulted from the delay in fully implementing the confirmed 1991 plan that can be measured by the professional fees and expenses of three courts and five proceedings. *In re Papercraft Corp., 247 B.R. 625, 628 (Bankr. W.D. Pa. Apr. 20, 2000).* The Bankruptcy Court held, therefore, that CVC's recovery would be further subordinated by (1) $1,248,000 for additional administrative expenses incurred during the four-month delay; (2) $956,250 for interest and dividends lost by creditors during the delay; and (3) $2,974,373.15 for professional fees and expenses incurred and/or paid by the Estate or BDK through April 30, 2000.[1] *In re Papercraft Corp., 253 B.R. 385, 390 (Bankr. W.D. Pa. Sep. 21, 2000).*

The District Court affirmed the Bankruptcy Court's decision, except that it reduced the lost interest income component of the subordination from $956,250 to $50,123.45. Memorandum Order at 36. CVC filed a timely appeal.

## II. Jurisdiction and Standard of Review

The District Court had subject matter jurisdiction over the appeal below pursuant to *28 U.S.C. § 158(a)* and appellate jurisdiction in accordance with Local Bankruptcy Appellate

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[1] The Bankruptcy Court also held that CVC's recovery would be further subordinated by $4,750 in United States Trustee fees incurred and/or paid by the Papercraft bankruptcy estate from the date of confirmation through May 2, 2000. *247 B.R. at 630.*

Rule 8007.1. We have jurisdiction pursuant to *28 U.S.C. § § 158(d) and 1291.*

We exercise plenary review over legal determinations of a district court sitting as an appellate court in a bankruptcy proceeding. *Fellheimer, Eichen & Braverman, P.C. v. Charter Techs., Inc., 57 F.3d 1215, 1223 (3d Cir. 1995).* We may only overturn factual findings, however, if they are "clearly erroneous." *Id*; *Fed. R. Bankr. P. 8013.* We must accept the District Court's factual findings "unless they are 'completely devoid of a credible evidentiary basis or bear[ ]no rational relationship to the supporting data.'" *Moody v. Security Pac. Bus. Credit, Inc., 971 F.2d 1056, 1063 (3d Cir. 1992)* (citation omitted).

III. Discussion

First, CVC argues that the Bankruptcy Court violated the American Rule by subordinating the attorneys' fees. We disagree.

The expression of the American Rule is found in *Alyeska Pipeline Service Co. v. Wilderness Soc'y*, where the Supreme Court explained that, "in the United States, the prevailing litigant is ordinarily not entitled to collect a reasonable attorneys' fee from the loser." *421 U.S. 240, 247, 44 L. Ed. 2d 141, 95 S. Ct. 1612 (1975).* There are, however, numerous exceptions to this rule. An element of all American Rule exceptions is a determination that the litigant "prevailed" and should be awarded attorneys' fees. For example, *42 U.S.C. § 1988* was enacted with the express intent of negating the effect of the *Alyeska* decision in statutory civil rights cases. 1976 U.S.C.C.A.N. 5908-09 ("The purpose of this amendment is to remedy anomalous gaps in our civil rights laws created by the United States Supreme Court's recent decision in *Alyeska Pipeline*. . . ."). Under *§ 1988*, a party must show it "prevailed" in the underlying action.

The District Court affirmed the Bankruptcy Court's subordination of attorneys' fees, explaining:

> The Committee is not asking for the payment of attorneys' fees as such. The fees and expenses at issue depleted funds that otherwise would have been available to creditors but for CVC's misconduct in breaching its fiduciary duty. To ensure the distribution creditors should have received absent CVC's misconduct, it is necessary to restore the Estate's funds 'by subordinating CVC's share of distribution by the amount of fees and expenses incurred by professionals who are to be paid from estate assets that would not have been incurred but for CVC's breach of its fiduciary duty.'

*In re Papercraft Corp.* , Memorandum Order *11 (W. D. Pa. February 20, 2002). We agree with the District Court's logic.

In the exercise of its powers as a court of equity, the bankruptcy court may subordinate claims for cause, applying traditional principles of equitable subordination. *11 U.S.C. § 510(c)*; *Pepper v. Litton, 308 U.S. 295, 307-11, 84 L. Ed. 281, 60 S. Ct. 238 (1939)*; *Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322, 83 L. Ed. 669, 59 S. Ct. 543 (1939)*; *see also Comstock v. Group of Institutional Investors, 335 U.S. 211, 229, 92 L. Ed. 1911, 68 S. Ct. 1454 (1948)* (narrowing the application of equitable subordination to situations in which bad faith by the claimant is found). Although *§ 510(c)* codifies the doctrine of equitable subordination, it does not detail the requirements of such subordination. Instead, it merely states that the doctrine is to be applied "under the principles of equitable subordination," and the legislative history states that Congress intended that the courts develop these principles. 124 Cong. Rec. 32,398 (1978) (statement of co-sponsor Rep. Edwards); 124 Cong. Rec. 33,998 (statement of co-sponsor Sen. DeConcini); *Burden v. United States, 917 F.2d 115, 118 (3d Cir. 1990)*.

The doctrine of equitable subordination is remedial, and the goal "'is to undo or to offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results.'" *Burden, 917 F.2d at 117* (citation omitted); *see also In re Papercraft Corp., 160 F.3d 982, 991 (3d Cir. 1998)* (stating that the purpose of equitable subordination is "to compensate in a manner that will permit a . . . remedy to the injury that has been suffered by those [creditors] who will benefit from the subordination"). "'The bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate.'" *Burden, 917 F.2d at 117* (quoting *Pepper, 308 U.S. at 307-08*). The inequitable conduct may arise out of any unfair act by the creditor as long as the conduct affects the bankruptcy results of the other creditors. *Matter of Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1997).* Because equitable subordination is remedial rather than penal, a claim should be equitably subordinated only to the extent necessary to offset the harm suffered by the debtor and its creditors as a result of the inequitable conduct. *Mobile Steel, 563 F.2d at 701.* A New York bankruptcy court has eloquently stated:

> The remedy of equitable subordination must remain sufficiently flexible to deal with manifest injustice resulting from the violation of the rules of fair play. . . . 'where ingenuity spawns unprecedented vagaries of unfairness, [bankruptcy courts] should not decline to recognize their marks, nor hesitate to turn the twilight for [offending claimants] into a new dawn for other creditors.'

*In re Teltronics Servs., Inc., 29 B.R. 139, 172 (Bankr. E.D.N.Y. 1983)* (citations omitted). We hold that because the Bankruptcy Court subordinated attorneys' fees pursuant to its equitable powers, the American Rule is not implicated.

The Bankruptcy Court did not award a money judgment for attorneys' fees to penalize CVC. Rather, the Bankruptcy Court analyzed the record facts, found specific damages, and used its equitable powers to return the non-selling creditors to the position they would have been in had CVC not acted inequitably.

We directed the Bankruptcy Court to make findings as to the amount of CVC's claims that should be subordinated pursuant to the principles of equitable subordination, and to identify specific harm resulting from CVC's wrongdoing. *In re Papercraft Corp., 160 F.3d at 991.* The Bankruptcy Court did so, and concluded that CVC's inequitable conduct justifies subordination of attorneys' fees. We hold that the finding is not clearly erroneous.

At trial, the Bankruptcy Court stated that "none of these litigation costs would have been incurred" but for CVC's inequitable conduct, 5 app. at 1364, and that "some reasonable litigation costs may actually be a direct consequence of CVC's activities in this case." 5 app. at 1365. The Bankruptcy Court found that, but for CVC's inequitable conduct, the Committee would not have incurred such substantial fees and costs. *In re Papercraft Corp., 247 B.R. at 628*; 28 app. at 8004-05. The Bankruptcy Court analyzed the depletion of available funds in the reorganized entity, and determined that the economic harm is directly attributable to CVC's inequitable actions. *In re Papercraft Corp., 247 B.R. at 628*; 29 app. 8326. The Bankruptcy Court also found that the fees and costs related to the litigation were a "third type of economic harm caused by CVC's undisclosed claims purchasing." *In re Papercraft Corp., 247 B.R. at 631.* The amount of attorneys' fees does not include all litigation costs of the Committee. Rather, more than $700,000 is deducted from the attorneys' fee award for fees and costs that are unrelated to CVC's inequitable conduct. 29 app. 8211-48.

CVC's inequitable conduct includes repeatedly litigating issues that were decided against it by our earlier decision, as well as earlier decisions of the District Court and the Bankruptcy Court. For example, in this case, CVC has incessantly relitigated the issue of whether it profited from its illegal claims trading, even though this issue had already been decided against it in the District Court, and reviewed by us. *In re Papercraft Corp., 165 B.R. 980, 983-84 (Bankr. W.D. Pa. 1994)*; *In re Papercraft Corp., 187 B.R. 486, 492, 498-99 (Bankr. W.D. Pa. 1995)*; *In re Papercraft Corp., 211 B.R. 813, 825 n. 12 (W. D. Pa. 1997)*; *In re Papercraft Corp., 160 F.3d 982, 990-91 (3d Cir. 1998)*. Also, in the briefs filed with the Bankruptcy Court on remand, 29 app. 8133-87, CVC attempted to relitigate that it did not usurp a corporate opportunity, even though all three courts had already found against CVC on this issue in previous *In re Papercraft Corp.* decisions. *160 F.3d at 987-88*; *211 B.R. at 820, 824-26*; *187 B.R. at 498-99*. Finally, CVC's collateral proceedings, for which CVC only had standing because it illegally purchased claims against Papercraft, were aimed at preventing the reorganized debtor from engaging in a value-enhancing sale transaction, and depleted monies that would have otherwise been available to the creditors. 29 app. 8216-17, 8245-46.

The Bankruptcy Court also determined that the testimony of CVC's representatives during the litigation was not credible. *In re Papercraft, 187 B.R. at 493 n. 3* (finding that all other credible testimony and evidence shows that the testimony of CVC's Saleem Muqaddam is false); *id. at 497* (dismissing the testimony of CVC's William Comfort, which contradicted other evidence); *id.* (disbelieving testimony of Muqaddam). Each of these instances of inequitable conduct resulted in legal fees and costs that decreased the funds available the non-selling creditors.

The Bankruptcy Court spent a substantial amount of time and effort considering the narrow issue of whether to include the professional fees and expenses in the subordination, 28 app. 8004-05; 29 app. 8288-335, and ruled on the issue in two written opinions. *In re Papercraft Corp., 247 B.R. at 631*; *In re Papercraft Corp., 253 B.R. at 387-90.* We conclude that the Bankruptcy Court found facts sufficient to establish the egregious conduct warranting subordination of CVC's claims, and those facts are not clearly erroneous. Although the pursuit of one's legal rights may not be grounds for equitable subordination, protracted and unjustified litigation tactics that harm the estate by causing it to incur fees may justify subordination. The Bankruptcy Court has been involved in overseeing this litigation for a decade and has had the best opportunity to observe first hand CVC's conduct and evaluate its motives. We are hard-pressed to disagree with its determinations based on the extensive record and proceedings before it, and its obvious familiarity with what we previously termed CVC's "machinations."

We reject CVC's other two arguments, as well as the Committee's argument on cross-appeal.

First, we conclude that the District Court did not err by holding that CVC was responsible for all fees incurred during a delay in the plan process. In our previous decision, we indicated that CVC's actions could have led to the delay in the BDK Plan's confirmation:

> Without limiting the inquiry of the bankruptcy court in any way, we note that there is evidence which would support a finding that the non-selling Papercraft creditors suffered injury from CVC's attempt to control the reorganization. . . . If CVC's pursuit of its own interest in fact resulted in delay in the confirmation, we do not read that finding as inconsistent with subordination based on injury resulting from that delay.

*In re Papercraft Corp., 160 F.3d at 991-92.* The Bankruptcy Court evaluated the evidence, and found ample support to establish that CVC's conduct delayed the plan process by at least four months, and that CVC's intent was to benefit itself over and above other creditors to whom it owed a fiduciary duty not to self-deal. *In re Papercraft, 247 B.R. at 628.* We have determined that the Bankruptcy Court's findings are not clear error.

Second, we conclude that the District Court did not err by affirming the Bankruptcy Court's calculation of CVC's profit. CVC argues that because it could only have realized a profit on the claim purchases if the cash equivalent of the BDK Units that it could receive under the BDK Plan exceeded the $10.5 million that CVC paid for the claims, the calculation must be the fair market value of those BDK Units. More than sufficient evidence demonstrates that the Bankruptcy Court did not err by valuing CVC's profit based on the reorganization value at the time of the BDK Plan confirmation. All of the creditors, including CVC, were to receive BDK Units on an equal basis, determined by their proportional share of interests in the reorganized entity, and we uphold the District Court's affirmation of the Bankruptcy Court's calculations.

Finally, the Committee argues that the District Court erred by reducing the subordination on account of lost interest income from $956,250 to $50,123. This argument is meritless. Because there was a four-month delay in the issuance of the debt securities, the Bankruptcy Court came to the $965,250 figure by multiplying the $239,062 in monthly interest on all the debt securities by four. The District Court correctly noted that the securities were ten-year notes, which would provide the Committee ten years of interest regardless of when they were issued. Mem. Order (Feb. 20,

2002), at 24-25. We therefore conclude that the District Court did not err by calculating the lost interest by a four-month delay of the ten years of interest.

For the foregoing reasons, we will affirm the judgment of the District Court.

**IN THE UNITED STATES DISTRICT COURT**
**FOR THE WESTERN DISTRICT OF PENNSYLVANIA**

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| In re: | |
| PAPERCRAFT CORPORATION, a Pennsylvania corporation, Debtor. | Civil Action No. 00-2181<br>Judge Robert J. Cindrich |
| CITICORP VENTURE CAPITAL, LTD., a New York corporation, Appellant, v. COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, and COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION, Appellee. | Bankruptcy No. 91-20903 JKF<br>Chapter 11<br>Adversary Proc. No. 91-2642 |

**MEMORANDUM ORDER**

This action arises from an April 20, 2000 and September 21, 2000 Memorandum Opinion and Order of the United States Bankruptcy Court for the Western District of Pennsylvania (the "Bankruptcy Court"), Bankruptcy Judge Judith K. Fitzgerald presiding. *In re Papercraft Corp.*, 247 B.R. 625

(Bankr. W.D. Pa. Apr. 20, 2000) ("April 20 Order") (cited as "247 B.R. at ___"); *In re Papercraft Corp.*, 253 B.R. 385 (Bankr. W.D. Pa. Sep. 21, 2000) ("September 21 Order") (cited as "253 B.R. at ___"). Pending before the Court is an appeal of the April 20 and September 21 Orders of Appellant Citicorp Venture Capital, Ltd. ("CVC"). This Court has jurisdiction over this matter pursuant to 28 U.S.C. Section 158 (a)(1) and in accordance with Bankruptcy Rule 8001 as the appeal arises out of a final judgment entered by the Bankruptcy Court.

## I. Background

This appeal arises out of the chapter 11 case of Papercraft Corporation ("Papercraft" or "Debtor"), which was filed in March 1991 in the United States Bankruptcy Court for the Western District of Pennsylvania (Fitzgerald, J.). The Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation (the "Committee"), the official unsecured creditors' committee in Papercraft's chapter 11 case,[1] commenced this action in October 1991 alleging that CVC, while an insider and fiduciary of Papercraft,[2] attempted to take control of Papercraft's assets and reap a

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[1] The Committee is the official unsecured creditors' committee in Papercraft's chapter 11 case, whose members were duly appointed by the United States Trustee under section 1102 of title 11 of the United States Code ('Bankruptcy Code"). The Committee has sued CVC not just in its capacity as a committee entitled to bring suit by virtue of sections 502, 1103, and 1109 of the Bankruptcy Code, but as "Estate Representative" which, under the provisions of the confirmed plan of reorganization, is entitled to enforce the rights of the estate and is empowered by section 1123(b)(3)(B) of the Bankruptcy Code to do so. Brief of Appellee Committee Of Creditors Holding Unsecured Claims And Committee Of Creditors Holding Unsecured Claims As Estate Representative Of Papercraft Corporation ("Committee's Br.") (Doc. No. 4) at 1 n.1.

[2] A representative of CVC sat on the boards of directors of Papercraft and Papercraft subsidiaries Barth & Dreyfuss and Knomark.

significant profit at the expense of other creditors by secretly purchasing $60,849,299.10 in claims against Papercraft for the deeply discounted amount of $10,553,541.88. The Committee contend that CVC breached its fiduciary duty to Papercraft and Papercraft's creditors by engaging in such self-dealing, and therefore sought to have CVC's claims equitably subordinated pursuant to Section 510(c) of the Bankruptcy Code, 11 U.S.C. Section 510(c).

After the close of a three-day trial, the Bankruptcy Court issued an October 12, 1995 Memorandum Opinion and Order, In re Papercraft Corp., 187 B.R. 486 (Bankr. W.D. Pa. 1995) (cited as "187 B.R. at ___") wherein the Court made detailed findings of fact. In brief, Papercraft was experiencing difficulty meeting the terms of certain debt obligations in the fall of 1999. An informal committee of Papercraft creditors was formed and after months of negotiations, the committee and Papercraft reached an agreement on a restructuring plan known as the "BDK plan" which was to be filed in conjunction with a voluntary chapter 11 petition. The creditor's claims against Papercraft would then be converted into "BDK units", consisting of stock and bonds issued by the new venture, in proportion to an estimated value of such units. Papercraft's directors, including CVC, unanimously approved the BDK plan in March 1991. Although the chapter 11 petition and BDK plan were filed in March 1991, the required Papercraft disclosure statement, a prerequisite to confirmation of the plan, was not filed until October 1991. CVC secretly purchased the $60.8 million in claims during this delay, more than 40% of the outstanding unsecured claims of Papercraft. Despite its earlier support of the BDK plan, CVC objected to the confirmation of the BDK plan and offered its own competing plan calling for a CVC purchase of Papercraft's assets.

The Bankruptcy Court found that CVC's purchases at a discount, without disclosure, while an insider, constituted breaches of CVC's fiduciary duty to Papercraft and its creditors. 187 B.R. at 498-99. As a result, the Bankruptcy Court created and applied a per se rule prohibiting a debtor's insider from purchasing claims against it without disclosing his or her identity and relationship with the debtor. The Court held that when claims are purchased by insiders without making such disclosures to the debtor and creditors, "the insider's newly acquired claim will be limited to the amount paid by the acquiring insider and recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim." *Id.* at 491. Under the Bankruptcy Court's holding, which limited CVC's allowed claim to the $10,553,541.88 price with recovery under the plan gauged to this amount, CVC would recover only about $3,063,600 in BDK units on its claims, approximately $7,489,941.88 less than what it paid. If CVC's claims were allowed at face, however, it would recover approximately $15,987,600 in BDK units, using the BDK plan's estimated value of BDK units. Thus, using the BDK plan's estimated value of BDK units, CVC stood to gain $5,434,058.12 in profit on the claims.

The Bankruptcy Court held that further subordination of CVC's claims pursuant to the principles of equitable subordination codified at 11 U.S.C. Section 510(c) was not appropriate. *Id.* at 501. The Court correctly noted that equitable subordination of a creditor's claim is proper when (1) the creditor has engaged in inequitable conduct; (2) such misconduct caused injury to other creditors or the debtor or resulted in an unfair advantage to the creditor; and (3) subordination of the creditor's claim is consistent with the Bankruptcy Code. *Id.* at 502 (citing *Matter of Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977)). The Bankruptcy Court found that the first two elements had been satisfied. *Id.* at 502. As to the third element, however, the court

concluded that the principles of fairness had already been adhered to because it was limiting CVC's allowed claim to the amount it paid for such claim. *Id.* Thus, further subordination of CVC's claim would not be consistent with the Bankruptcy Code. *Id.*

On appeal, we affirmed the Bankruptcy Court's factual findings, i.e., that CVC breached its fiduciary duties, acted inequitably, caused injury to Papercraft and its creditors and gained an unfair advantage. *In re Papercraft Corp.*, 211 B.R. 813 (W.D. Pa. 1997) (cited as "211 B.R. at ___"). Although we agreed that pursuant to Section 510(c) CVC's recovery should at a minimum be limited to the amount paid for such claims to eliminate any potential profits on the claims, we reversed the Bankruptcy Court's ruling as to the application of a per se rule finding no authority for the creation of such a rule. *Id.* at 821, 826. Accordingly, we remanded the case to the Bankruptcy Court for a further finding on the amount CVC's claims should be subordinated beyond the amount paid for such claims, if at all, pursuant to the principles of equitable subordination. *Id.* at 827. Both parties appealed our decision.

The United States Court of Appeals for the Third Circuit affirmed our decision concluding that CVC violated its fiduciary duty in a number of significant respects and that CVC's misconduct caused harm justifying subordination. *Citicorp Venture Capital Ltd. v. Committee of Creditors Holding Unsecured Claims*, 160 F.3d 982, 988-90 (3d Cir. 1998) (cited as "160 F.3d at ___"). The Court of Appeals affirmed the Bankruptcy Court's findings of fact concluding that such "findings make this a paradigm case of inequitable conduct by a fiduciary as that concept has been developed in the case law, and we believe that further elaboration is not required." *Id.* at 987. The Court of Appeals further held:

At a minimum, the remedy here should deprive CVC of its profit on the purchase of the notes. That can be accomplished by subordinating CVC's claims under Section 510(c) to the extent necessary in order to limit its recovery to the purchase price of the notes. Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles.

By so concluding, we do not suggest that a bankruptcy court can never impose a subordination remedy beyond disgorgement of profit without putting a specific price tag on the loss suffered by those who will benefit from the subordination. Such quantification may not always be feasible and, where that is the case, it should not redound to the benefit of the wrongdoer. A bankruptcy court should, however, attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the remedy to the injury that has been suffered by those who will benefit from the subordination.

* * *

While we agree with CVC's criticism of the bankruptcy court's remedy, we decline to accept its argument that the record is devoid of any evidence that would support a remedy going beyond disgorgement of profit. Without limiting the inquiry of the bankruptcy court in any way, we note, that there is evidence which would support a finding that the non-selling Papercraft creditors suffered injury from CVC's attempt to control the reorganization. While the bankruptcy court held, with record support, that the delay between the filing of the petition and the filing of the disclosure statement was not attributable to CVC's machinations, it made no similar finding with respect to the period of delay

> between the filing of the disclosure statement and confirmation of the BDK plan. Moreover, while the bankruptcy court found "no evidence that CVC engaged in conduct designed to delay the plan process," if CVC's pursuit of its own interest in fact resulted in delay of the confirmation, we do not read that finding as inconsistent with subordination based on injury resulting from that delay. On remand, the bankruptcy court should consider whether the record supports the proposition that non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan.

*Id.* at 991-92.

On remand, the Bankruptcy Court found that in accordance with the opinion of the Court of Appeals, CVC's maximum recovery cannot exceed $10,553,541.88, i.e., the cost of CVC's claims. 253 B.R. at 390. The Bankruptcy Court also found that:

> CVC's conduct resulted in three categories of economic harm to non-selling noteholder creditors. The first two encompass (a) the delay in confirming the plan which resulted in harm that is quantifiable in terms of dollars and (b) the uncertainty over the amount of CVC's claim distribution thereon that is not easily quantifiable. The third relates to the filing of this adversary which, through the appellate and remand process, has created a delay in fully implementing the confirmed plan of over four years from the date of may initial opinion (October 12, 1995) to today and of eight years since this adversary was filed on October 31, 1991. At the very least, while this adversary has been pursued through three courts and five proceedings, this delay has caused debtor to incur professional fees and expenses and additional U.S. Trustee quarterly fees which must be paid until this case is, *inter alia*, closed.

247 B.R. at 628 (footnote and citations omitted). The Bankruptcy Court further found that CVC's misconduct resulted in at least a four month delay in connection with the first category of harm — delay in confirmation of the BDK plan. *Id.* at 630. The Bankruptcy Court held, therefore, that CVC's recovery would be further subordinated by (1) $1,248,000 for additional administrative expenses incurred during the four month delay; (2) $956,250 for interest and dividends lost by creditors during the delay; (3) $4,750 in United States Trustee fees incurred and/or paid by the Papercraft bankruptcy estate (the "Estate") from the date of confirmation through May 2, 2000; and (4) $2,974,373.15 for professional fees and expenses incurred and/or paid by the Estate or BDK through April 30, 2000 for a total additional subordination of $5,183,373.15. 253 B.R. at 390. With a starting point of $10,553,541.88 (CVC's actual investment), minus $5,183,373.15 in additional subordination, CVC's total unsubordinated distribution equals $5,370,168.73. *Id.*

II. Standard of Review

While acting as an appellate court for a bankruptcy appeal, we may not set aside the Bankruptcy Court's factual findings unless we conclude that the determination was "clearly erroneous." Bankruptcy Rule 8013; *Fellheimer, Eichler & Braverman, P.C. v. Charter Technologies, Inc.*, 57 F.3d 1215, 1223 (3d Cir. 1995); *First Jersey Nat'l Bank v. Brown (In re Brown)*, 951 F.2d 564, 567 (3d Cir. 1991). Consequently, we accept the ultimate determination of the fact finder "unless that determination either is completely devoid of minimum evidentiary support displaying some hue of credibility or bears no rational relationship to the supportive evidentiary data." *Hoots v. Commonwealth of Pennsylvania*, 703 F.2d 722, 725 (3d Cir. 1983). In considering the evidence, "due regard shall be given the opportunity of the bankruptcy court to judge the credibility of the witnesses." Bankruptcy Rule 8013; *Fellheimer*, 57 F.3d at 1223.

Our review of the legal determinations made by the Bankruptcy Court is plenary. *Brown v. Pennsylvania St. Employees Credit Union (In re Brown)*, 851 F.2d 81, 84 (3d Cir. 1988). Mixed questions of law and fact must be divided into their component parts and the appropriate standard applied to each. *See Universal Minerals, Inc. v. C.A. Hughes & Co.*, 669 F.2d 98, 101-103 (3d Cir. 1981).

III. Analysis

CVC raises numerous issues in its appeal which we address in turn.

A. American Rule

CVC argues that the Bankruptcy Court erred in the subordination of its claims for $2,974,373.15 in professional fees and expenses incurred and/or paid by the Estate. CVC contends that absent some statutory or contractual authorization, the American Rule requires litigants to bear their own attorneys' fees.

As the Bankruptcy Court rightly reasoned, the American Rule does not apply under the circumstances of the instant case. The Committee is not asking for the payment or attorneys' fees as such. The fees and expenses at issue depleted funds that otherwise would have been available to creditors but for CVC's misconduct in breaching its fiduciary duty. To ensure the distribution creditors should have received absent CVC's misconduct, it is necessary to restore the Estate's funds "by subordinating CVC's share of distribution by the amount of fees and expenses incurred by professionals who are to be paid from estate assets that would not have been incurred but for CVC's breach of its fiduciary duty." 253 B.R. at 391.

CVC argues in the alternative that even if fees are properly recoverable, the Bankruptcy Court failed to make a finding that the fees awarded were reasonable. CVC contends that the party seeking fees has the burden of establishing that

the fees sought are reasonable and that the court must make a finding that such fees are reasonable before making an award.

In contrast to the typical cases involving fee-shifting statutes, such as federal employment discrimination and civil rights cases where a successful plaintiff is entitled to an award of reasonable attorneys' fees, the Bankruptcy Court determined that it was appropriate to subordinate CVC's claims by the fees and expenses actually incurred as a result of the instant litigation to put Papercraft's creditors in the position they would have been in but for CVC's misconduct. Somewhat akin to the legal maxim that a tortfeasor takes his victim as he finds him, CVC must live with the fees actually incurred by the Estate even if those fees, in hindsight, were high in comparison to some general market rate.

In any event, there is nothing that would indicate that the $2.9 million figure is unreasonable. The Bankruptcy Court required the Committee to file a statement of fees and expenses that had been incurred in connection with the adversary proceeding and gave CVC an opportunity to file objections to the same. Other than one conclusory, general objection to the amount of one category of fees, however, CVC does not identify any specific rates or hours that it objects to as being unreasonable. Indeed, given the protracted litigation surrounding this 1991 case, which entailed numerous hearings, a full evidentiary trial, three appeals and filings measured by the yard, all of which was caused by CVC's illegal self-dealing, the $2.9 million in fees and expenses is not out of line with figures we have seen in cases of similar duration and volume of filings and proceedings.

CVC also argues that several categories of fees should not be allowed because they cannot be attributed to any conduct by it. CVC made this same argument before the Bankruptcy Court which held in response "that none of the amount at issue incurred during preconfirmation delay or

associated with the Adversary would have been incurred but for CVC's conduct. Therefore, all of it is attributable to CVC and CVC's claim is to be subordinated by that amount." 253 B.R. at 390. This is a finding of fact by the Bankruptcy Court which we must accept unless such determination is either "completely devoid of minimum evidentiary support displaying some hue of credibility or bears no rational relationship to the supportive evidentiary data." *Hoots*, 703 at 725. The Bankruptcy Court's finding most certainly bears a rational relationship to the evidence. For example, CVC used its position on Papercraft's board of directors to arrange for the preparation of financial reports and other information by Papercraft personnel, without the Committee's knowledge, to use in preparation of a competing plan. 247 B.R. at 628-29. As a result, the Committee's requests for information were stymied while Papercraft was providing information to CVC. *Id.* at 629. All the while, CVC was surreptitiously purchasing claims. 160 F.3d at 985. CVC submitted its competing plan only to withdraw it shortly after the Bankruptcy Court approved the BDK plan. *Id.* CVC then filed objections to the BDK plan. *Id.* Indeed, based on the facts as found by the Bankruptcy Court, and later affirmed by this court and the Court of Appeals, it is quite clear that CVC has acted at every turn to stymie the fair and efficient administration of the Estate in an effort to capitalize on its self-dealing.

Lastly, CVC maintains that it should be responsible for any of the fees and expenses associated with the various appeals and should only be accountable for fees and expenses incurred during proceedings before the Bankruptcy Court. We disagree. None of these proceedings would have been necessary, including these appeals, but for CVC's misconduct. Papercraft's creditor's should not have to bear the expense of these appeals which were caused solely by CVC's actions. Subordination of CVC's claims for these fees is necessary to make the Estate whole.

Accordingly, the Bankruptcy Court's decision to further subordinate CVC's claims by $2,974,373.15 for professional fees and expenses will be affirmed.

B. Delay Costs

1. Delay Between Filing of Petition and Disclosure Statement

CVC argues that the Bankruptcy Court did not make sufficient findings to support subordination of its claims for the delay between the filing of the bankruptcy petition and the disclosure statement. CVC further contends that the evidence does not support a finding that it is responsible for any such delay.

In its initial decision, the Bankruptcy Court commented that it had found no evidence that CVC had engaged in conduct designed to delay the plan process. 187 B.R. at 501. The Court of Appeals held, however, that although the Bankruptcy Court had already made a finding of no designed delay, "if CVC's pursuit of its own interest in fact resulted in delay of the confirmation, we do not read that finding as inconsistent with subordination based on the delay." 160 F.3d at 992. The Bankruptcy Court was instructed to consider on remand, therefore, "whether the record supports the proposition that the non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan." *Id.* The Bankruptcy Court did just that.

The Bankruptcy Court explained its ruling as follows:

> When a chapter 11 plan which has been approved by creditors prepetition is filed early in the case, a disclosure statement explaining the basis for the plan should be filed with that plan or shortly thereafter. In fact, the record shows that this was the expectation of all parties when the case was filed. The expectation was not realized in this case because CVC used its

> insider position to get information from the Debtor that it needed in order to facilitate its claim purchasing. Its claim purchases gave CVC leverage in the reorganization process and enabled it to control votes which, in turn, facilitated its purchase offer. The purchase offer was memorialized in the unusual occurrence of Debtor's filing a competing plan of reorganization (the CVC plan) that proposed an entirely different reorganization (i.e., a sale to Citicorp) from the BDK plan originally filed by Debtor and which Debtor did not withdraw. The Committee's requests for information which would enable it to assist Debtor in drafting the disclosure statement were stymied while Debtor provided information to CVC and delayed providing it to the Committee. *See* Declaration of Samuel M. Victor In Support of Equitable Subordination of CVC's Claims (hereafter "Victor Declaration"), Adv. Docket # 116 attached to Appendix of Opening Brief of Committee, Adv. Docket # 189 at P 14. In that way, CVC caused the delay in Debtor's filing of the disclosure statement for the initial BDK plan and created significant unnecessary expense to this estate — in the millions of dollars in terms of a combination of professional fees, litigation expenses and U.S. Trustee quarterly fees due as the result of a statutory amendment to 28 U.S.C. Section 1930(a)(6) and the Third Circuit Court of Appeals' decision in *United States Trustee v. Gryphon at the Stone Mansion, Inc.*, 166 F.3d 552 (3d Cir. 1999).

247 B.R. at 629.

Federal Rule of Civil Procedure 52(a) requires a Bankruptcy Court to "find the facts specifically and state separately its conclusions of law thereon . . . ."

> One of its chief purposes is to 'aid the appellate court by affording it a clear understanding of the ground or basis of the decision of the trial court.' 9 C. WRIGHT

> & A. MILLER, FEDERAL PRACTICE AND PROCEDURE, Section 2571, at 679. Where the trial court provides only conclusory findings, unsupported by subsidiary findings or by an explication of the court's reasoning with respect to relevant facts, a reviewing court simply is unable to determine whether or not those findings are clearly erroneous.

*Lyles v. United States*, 759 F.2d 941 (D.C. Cir. 1985) (citations and footnote omitted). Despite CVC's contention to the contrary, the Bankruptcy Court's detailed findings as to the delay are very specific and most certainly satisfies Rule 52(a)'s requirements. A reviewing court would have a clear understanding of the ground or basis of the Bankruptcy Court's decision and the facts which the court relied on.

As to the sufficiency of the evidence, CVC selectively cites certain facts in support of its version of events and argues that its activities did not cause a delay. The Bankruptcy Court, however, is the fact finder in this case and reached a different conclusion. Indeed, the Bankruptcy Court made detailed findings of fact as to CVC's covert commandeering of Papercraft's resources to assist in the preparation of a competing plan and cites testimonial evidence of Samuel M. Victor indicating that CVC's actions caused a delay. Although CVC would have us weigh this evidence differently, we cannot say that the Bankruptcy Court's finding on this point was clearly erroneous.[3]

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[3] CVC makes much of the Bankruptcy Judge's comments at an August 29, 1991 hearing regarding certain satellite litigation that she believed necessitated the granting of an extension of time to file the disclosure statement. CVC argues that the Bankruptcy Judge improperly ignored these prior comments when later finding that CVC was responsible for the delayed filing of the disclosure statement. The Bankruptcy Judge's prior comments and instant findings are not inconsistent. At the subsequent trial in this matter, the Bankruptcy Judge heard extensive evidence and concluded that the delay in the filing of the disclosure statement was not caused by the satellite litigation. *See* 253 B.R. at 388. Contrary to

We find, therefore, that the Bankruptcy Court's decision to subordinate CVC's claims for the delay between the filing of the bankruptcy petition and plan confirmation was not clearly erroneous. Accordingly, the Bankruptcy Court's ruling on this issue will be affirmed.

2. Delay Between Filing of Disclosure Statement and Plan Confirmation

CVC argues that the there is insufficient evidence to find that it is responsible for any delay between the time of the filing of the disclosure statement and confirmation of the BDK plan. More specifically, CVC contends that the Bankruptcy Court's finding that CVC instigated a stall in order to pursue its self-interest in having Papercraft present its competing plan was based solely on the fact that it objected to the BDK plan. CVC contends, therefore, that the only fact cited in support of the finding that it was responsible for the delay was renounced by the Bankruptcy Court.

We disagree with CVC's assessment of the significance of the Bankruptcy Court's comment. The Bankruptcy Court did state in its April 2000 opinion that CVC caused the delay, but subsequently stated in its September 2000 opinion that CVC's objections "did not necessarily cause a delay." 253 B.R. at 389 n. 8; *see* 247 B.R. at 630. In its September 2000 opinion, the Court stated:

> After the BDK disclosure statement was approved, the plan confirmation hearing was set but CVC used its new position as a noteholder to assert objections to

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CVC's position, the Bankruptcy Judge was not bound by her prior comments in connection with the extension of time when making a finding as to the cause of the delay after a full trial. Indeed, as the Bankruptcy Court points out, "at the August, 1991, hearing neither Debtor nor CVC disclosed CVC's efforts to acquire financial information and its trading in claims. Thus, the court was not given the complete picture of the circumstances that caused delay at that time." 253 B.R. at 388 n.7.

> the plan, despite having participated in approving it prepetition. Although CVC's assertion of objections to the plan did not necessarily cause a delay between the filing of the disclosure statement and confirmation of the plan, its conduct led to increased professional fees in this case because its objections had to be addressed and plan language changed to reflect a compromise reached by the parties.

253 B.R. at 389 n.8. Thus, CVC put itself in a position via self-dealing in Papercraft claims to raise objections to the BDK plan in pursuit of its self-interest. CVC's objections, in turn, caused the Estate to incur additional fees and expenses to the detriment of the non-selling creditors separate and apart from any expenses caused by a delay. In other words, CVC would not have been in a position to pursue its self-interest by raising objections to the BDK plan absent its self-dealing. Thus, the added fees and expenses the Estate was forced to incur as a result of CVC's objections, were fairly included in the subordination of CVC's claims.

Moreover, we do not interpret the September 2000 opinion as a retraction of the Bankruptcy Court's earlier finding that CVC caused a delay in plan confirmation. The Court stated in the April 2000 opinion:

> I find that CVC caused the delay between the filing of the BDK disclosure statement and the confirmation of the BDK plan. CVC objected to confirmation of the BDK plan, even though it was one which CVC helped negotiate prepetition as a member of Debtor's board of directors. The credible evidence supports the conclusion that CVC instigated the stall in order to further pursue its self interest in having the Debtor present CVC's alternative plan. This caused specific economic harm and further litigation and attendant professional fees and costs.

247 B.R. at 630. The Court's discussion of delay in the September 2000 opinion, with regard to delay between the filing of the petition and disclosure statement and delay between the filing of the disclosure statement and plan confirmation, appears under the heading "Delay in Confirmation." 253 B.R. at 388-89. The Court opined that,

> [t]he fair inference from the events is that CVC used its status on Debtor's board of directors and on Debtor's affiliates' board of directors, together with its then newly acquired vote blocking position for the BDK plan to influence Debtor to file the CVC plan, thereby delaying the entire process.

253 B.R. at 388 n.7.[4] Shortly thereafter, the Court makes the statement that CVC's assertion of objections "did not necessarily cause a delay" as quoted in full above. *See* 253 B.R. at 388-89. In this context, the statement "did not necessarily cause a delay" is more fairly interpreted as conveying the opinion that CVC's conduct caused economic harm regardless of whether such conduct actually caused a delay. Indeed, as we explain above, CVC's objections to the BDK plan did

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[4] It is certainly a fair inference that CVC took unfair advantage of its position to push the CVC plan resulting in a delay in plan confirmation. In fact, the Court of Appeals indicated that the evidence of record was sufficient to support subordination of CVC's claims because of the delay. The Court stated:

> [T]he Committee points us to trial testimony from its financial advisor indicating that this competing reorganization plan and CVC's associated objections to the BDK plan resulted in confirmation delay that inflicted substantial injury on Papercraft's non-selling creditors.
>
> The bankruptcy court did not attempt to quantify the harms caused in economic terms, and CVC characterizes them as "non-ecomonic" harms. We do not agree with this characterization, however, and, like the bankruptcy and district courts, we conclude that they are sufficient to justify subordination.

160 F.3d at 990.

cause economic harm to the non-selling creditors regardless of whether those objections caused any delay between the filing of the disclosure statement and plan confirmation.

We find, therefore, that the Bankruptcy Court's decision to subordinate CVC's claims for the delay between the filing of the bankruptcy petition and plan confirmation was not clearly erroneous. Accordingly, the Bankruptcy Court's ruling on this issue will be affirmed.

C. Calculation of Damages

CVC argues that the Bankruptcy Court's calculation of damages was erroneous.

1. Pre-Confirmation Administrative Expenses

CVC argues that the Bankruptcy Court erroneously assessed all of the $1,248,000 in administrative expenses against its claims. More specifically, CVC references various categories of expenses arguing that certain charges are not attributable to any delay caused by it and/or would have been incurred regardless of any delay. CVC maintains that it is responsible for at most $584,812.19 for these expenses.

The Bankruptcy Court's finding on administrative expense is subject to a clearly erroneous standard. Thus, we must accept the Bankruptcy Court's finding unless it is completely devoid of minimum evidentiary support or bears no rational relationship to the supportive evidentiary data. The Bankruptcy Court concluded as follows in connection with administrative expenses:

> The trial record reflects that as of October, 1994, administrative expenses during the delay in plan confirmation totaled $1,248,000.[1a] Victor Declaration at

[1a] The figures used herein are based on an estimate of a delay of four months. See Victor Declaration at P 26. 1 find the four month delay to be a conservative estimate inasmuch as the BDK plan was filed shortly after

> P 26. Mr. Victor included all administrative costs incurred during the four month delay in this total because the Committee was not aware of CVC's actions in purchasing its claims. Thus, the Committee was unable to factor out any particular task for which a fee was incurred as attributable to something other than the delay. See Trial Transcript of November 14, 1995, at 71-72. Moreover, once the CVC plan was filed it became necessary for the Committee to address it. Any fees and expenses incurred in connection with the CVC plan, therefore, are attributable to CVC's undisclosed claims purchases and constitute a direct economic harm to the estate.

247 B.R. at 630. Thus, the Bankruptcy Court arrived at the $1.2 million dollar figure based on the supportive evidence of record. Contrary to CVC's position, the Bankruptcy Court did not have to arrive at this figure with precise accuracy. *See* 160 F.3d at 991 ("[W]e do not suggest that a bankruptcy court can never impose a subordination remedy beyond disgorgement of profit without putting a specific price tag on the loss suffered . . . ."). CVC's surreptitious self-dealing inhibited the Committee's ability to factor out any particular task for which a fee was incurred as attributable to something other than the delay. Thus, the difficulty at arriving at such quantification should not redound to the benefit of CVC — the wrongdoer in this case. *Id.* (Specific "quantification may not always be feasible and, where that is the case, it should not redound to the benefit of the wrongdoer.").

We find, therefore, that the Bankruptcy Court's decision to subordinate CVC's claims for $1,248,000 in administrative expenses was not clearly erroneous. Accordingly, the Bankruptcy Court's finding on this issue will be affirmed.

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the bankruptcy case was filed in March of 1991 and the plan was not confirmed until January 21, 1992.

2. Lost Interest

CVC argues that the Bankruptcy Court erroneously calculated the amount of lost interest income attributable to the delay.[5]

Under the BDK plan, creditors expected to receive on confirmation, and did receive, new debt securities with a face value of $33,750,000 bearing interest at the rate of 8.5% for ten years. The Bankruptcy Court found that CVC's actions caused a four month delay in plan confirmation, which in turn resulted in a four month delay in the issuance of the new debt securities. The Bankruptcy Court concluded, therefore, that the amount of lost interest attributable to the delay was $965,250, the amount of interest that would have been earned on the new notes over a four month period. The calculation was as follows:

- $33,750,000 x 8.5% = $2,868,750 interest per year
- $2,868,750 / 12 months = $239,062.50 interest per month
- $239,062.50 x 4 months = $956,250

253 B.R. at 389.

CVC contends that the new debt securities issued under the BDK plan were ten year notes, and were always intended to be ten year notes. Thus, the creditors expected to receive on confirmation, and did receive, a note bearing interest at the rate of 8.5% for ten years, not nine years and eight months. CVC argues, therefore, that the four month delay only resulted in the loss of the time value of the first four months of interest on the new debt securities. We agree.

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[5] CVC also contends that it should not have been charged for any lost interest because it is not responsible for any delay. We have already held that the Bankruptcy Court's finding that CVC caused a delay in plan confirmation is not clearly erroneous. Thus, we need not address CVC's delay argument again here.

The creditors expected to receive, and did receive, ten year notes bearing interest at 8.5%. In other words, the total amount of interest that the creditors will receive on these notes would not be different regardless of whether they had been issued four months earlier. If the four month delay had not occurred, for example, the creditors would not have received $33,750,000 in notes bearing interest at a rate of 8.5% for ten years and four months. Likewise, as CVC points out, the creditors did not receive notes bearing interest at a rate of 8.5% interest for a period of nine years and eight months because of the delay. Thus, the only harm the creditors could have suffered as a result of the four month delay was the loss of the time value money on the accrual of the first four months of interest earned on the notes. We agree with CVC that the simplest way to calculate this amount is to take the monthly interest of $239,062 and calculate the interest that would have accrued had the first semi-annual installment been made four months earlier. Taking the rate assigned to the notes, 8.5% per annum, times the four month interest "payment" of $956,250, you arrive at $81,281.25 as the "annual interest", divided by three [four months of the year is one-third], equals $27,093.75. Because it is now approximately ten years later than the expected confirmation date, the lost interest of $27,093.75 should be multiplied by 8.5% to determine the interest that could have been earned on the lost interest over one year,[6] which totals $2,302.97, which in turn should be multiplied by ten years[7] for a total of

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[6] The 8.5% time value rate should equal the actual market rate of interest that could have been earned on the funds. There is no evidence of record as to what the actual market rate was during the relevant time period. Thus, the market rate could have been more or less than 8.5% at various points in time. However, because CVC used this rate and the Committee did not object to, we will accept the 8.5% rate.

[7] CVC uses nine years in its calculation which was the correct number at the time its brief was filed. As of the date of this memorandum order, however, more than ten years has elapsed since the expected confirmation date.

$23,029.70. Thus, the creditors' total time value loss of the first four months of interest equals $50,123.45 ($27,093.75 + 23,029.70).

We find, therefore, that the Bankruptcy Court's calculation of the amount of lost interest income attributable to the four month delay was clearly erroneous. Accordingly, the Bankruptcy Court's decision on this issue will be reversed and the case remanded to the Bankruptcy Court for the entry of an order subordinating CVC's claims for lost interest income in the amount of $50,123.45.

3. Post-Confirmation U.S. Trustee Fees

CVC argues that although there were other open matters affecting the accrual of U.S. Trustee fees post-confirmation, the Bankruptcy Court attributed the entire first post-confirmation quarter fees of $4,750 to CVC's conduct.[8]

The Bankruptcy Court held as follows in connection with the U.S. Trustee Fees:

> CVC has no basis upon which to challenge the amount of the U.S. Trustee post-confirmation quarterly fees inasmuch as those fees are statutory and their accrual is directly caused by CVC's conduct. That is, but for CVC's wrongdoing, this bankruptcy case would have been closed shortly after plan confirmation on January 21, 1992 . . . .

247 B.R. at 631 n.9. In support of its objection to the Bankruptcy Court's determination, CVC merely cites "General Bankruptcy Court Docket" and conclusively argues that the trustee fees would have been incurred regardless of its actions

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[8] CVC also argues that its claims should not be charged with any U.S. Trustee fees incurred pre-confirmation, because it is not responsible for any delay. We have already held that the Bankruptcy Court's finding that CVC caused a delay in plan confirmation is not clearly erroneous. Thus, we need not address CVC's delay argument again here.

due to other pending matters. CVC's Br. (Doc. No. 2) p.29. CVC does not specify, however, what those matters were and how they affected the continuation of the bankruptcy case. We cannot find that the Bankruptcy Court's ruling on the trustee fees was clearly erroneous based on such a vague objection.

Accordingly, the Bankruptcy Court's decision to subordinate CVC's claims for $4,750 in U.S. Trustee fees will be affirmed.

D. Fair Market Value of BDK Units

CVC argues that the Bankruptcy Court erred in finding that it profited from the purchases of Papercraft claims because the court failed to consider the fair market value of the BDK units disbursed under the BDK plan in exchange for those claims. More specifically, CVC contends that the parties agree that the proper date for determining whether it made a profit is January 1992, when the BDK plan was confirmed. CVC maintains that although it purchased its claims for approximately $10.5 million in cash, the BDK plan provided a distribution of BDK units to creditors instead of cash. CVC contends, therefore, that calculation of profit must be based on the cash equivalent of BDK units as of January 1992, which reveals that it made no profit on its purchases.

The Bankruptcy Court rejected CVC's argument that its claims should be revalued to calculate CVC's profit. The Bankruptcy Court explained:

> I reject this method of valuation in this instance. Valuation of BDK units was determined at the time of plan confirmation to be $1,228 per unit and no different valuation was presented at the trial of this Adversary even though one issue tried was equitable subordination. Other (nonselling) creditors have received distribution based on that valuation. It would exacerbate the harm to these creditors if BDK units were valued differently

> now and only for CVC's claim. The operative date of valuation for plan purposes and for purposes of this adversary was the date of plan confirmation. CVC must live with the situation it created. . . . [2a]

247 B.R. at 632.

The Committee makes a persuasive argument that under res judicata principles CVC is precluded from arguing for a revaluation of its claims to calculate profits. As the Committee correctly points out, the existence and amount of profit attributable to CVC's claims purchasing has been at the heart of this litigation from its inception. The parties and the courts have always proceeded on the assumption that the value of BDK units as described in the BDK plan is the value upon which CVC's profits are calculated. This is the first time CVC has argued that its BDK units should be revalued. Apparently, CVC did not appeal the order confirming the BDK plan and accepted a distribution of BDK units based on

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[2a] CVC has provided no authority for its argument that its claim should be valued on a basis different from that of all other creditors. To do so would be inequitable to other creditors, at least under the circumstances of this case. To achieve parity in distribution in these classes as the Bankruptcy Code requires, the court must maintain the same valuation method utilized for all distributions of BDK units to creditors in classes entitled to them. All creditors in the affected classes will sustain the same increase or diminution in the value of their holdings as CVC. Moreover, the parties had a full opportunity to litigate all issues at trial and specifically requested, prior to trial, that I withdraw my opinion on summary judgment so that the equitable subordination issues could be addressed. I did so and the case was tried in November of 1994 to address these issues. Reopening the record over 5 years after trial concluded would violate principles of finality and create a never-ending round robin of Litigation.

the values established therein.[9] The value of the BDK units and the methodology for their distribution under the BDK plan were at issue during plan confirmation proceedings and the final disposition of those issues should be binding on CVC under res judicata principles. *See, e.g., Laborer's Int'l Union, AFL-CIO v. Foster Wheeler Corp.*, 26 F.3d 375, 396-97 n.24 (3d Cir. 1994) ("If an appeal is taken from only part of the judgment, the remaining part is res judicata . . . ." (citation omitted)).

In any event, we agree with the Bankruptcy Court and the Committee in that CVC's profits should be calculated in relation to the estimated value of BDK units appearing in the BDK plan. The Bankruptcy Code provides that a reorganization plan cannot be confirmed unless each creditor will receive at least as much in reorganization as it would in liquidation. *See* 11 U.S.C. Section 1129(a)(7)(A)(ii). Thus, the BDK units had to be valued in order to confirm the BDK plan. The valuation method used for the BDK units, a discounted cash flow analysis based on forward-looking income projections, is the methodology typically employed for such valuations and satisfies the Bankruptcy Code.[10]

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[9] Indeed, the Committee notes that the CVC's competing cash offer provided that CVC would pay approximately $40 million for Papercraft as an alternative to the BDK plan, which CVC represented was a fair value for the company. Committee's Br. (Doc. No. 4) pp. 25-26. The BDK plan's valuation of $40,052,000 is nearly identical to CVC's $40 million offer. *Id.* at p. 26.

[10] *See Consolidated Rock Prods. Co. v. DuBois*, 312 U.S. 510, 525-26 (1941):

> Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a sine qua non to a determination of the integrity and practicability of the new capital structure. It is also essential for satisfaction of the absolute priority rule . . . .

After an appropriate valuation, Section 1129 of the Bankruptcy Code requires parity in distribution among the different classes of creditors. The same valuation method must be used for all distributions of BDK units to achieve such parity. As a result, all creditors will be subject to the same increase or diminution in value of their interest in the reorganized entity. If the court were to accept CVC's revaluation argument, however, CVC would in essence receive a cash distribution for its BDK units while the remaining non-selling creditors bear the risk of receiving less in value than what they paid for their claims. Thus, revaluing only CVC's claims would subvert the parity achieved in distribution and expose the non-selling creditors to even greater harm. In other words, the non-selling creditors' exposure to a diminution in value of their claims caused by normal market risk would be exacerbated by a reduction

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> [T]he commercial value of property consists in the expectation of income from it. . . . Such criterion is the appropriate one here, since we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties. It is plain that valuations for other purposes are not relevant to or helpful in a determination of that issue, except as they may indirectly bear on earning capacity. The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable. Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. A sum of values based on physical factors and assigned to separate units of the property without regard to the earning capacity of the whole enterprise is plainly inadequate.

(citations and quotations omitted).

in their proportionate share of the reorganized entity as a result of CVC's claims being assigned a higher cash value. This cannot be. As the Bankruptcy Court noted, CVC, the wrongdoer here, must live with the situation it created.

Accordingly, the Bankruptcy Court's decision not to re-value CVC's claims to calculate its profits will be affirmed.

E. Other Purchasers

CVC contends that neither Papercraft nor members of the Committee could have or would have purchased the claims it purchased. CVC maintains, therefore, that it did not divert a corporate opportunity when it purchased the claims, and thus did not cause harm to the Estate.

With regard to this issue, the Bankruptcy Court stated:

> I need not consider this matter as all of my findings have been sustained on appeal and the only issue on remand is whether CVC's claim should be equitably subordinated beyond removal of its profit. However, I note that whether another entity would have availed itself of the opportunity is irrelevant. As the Court of Appeals pointed out in its opinion, under *Brown v. Presbyterian Ministers*, 484 F.2d 998, 1005 (3d Cir. 1973), the opportunity to purchase the notes was a corporate opportunity of which CVC could not avail itself, consistent with its fiduciary duty, without giving the corporation and its creditors notice and an opportunity to participate.

247 B.R. at 632 (quoting 160 F.3d at 987). We agree with the Bankruptcy Court's assessment of the narrow issue that was to be considered on remand and also agree that CVC's corporate opportunity argument should not be revisited. CVC made the same argument, and lost, both at trial and on appeal to this court and the Court of Appeals.

Based on a partial quote from the Court of Appeals' decision, however, CVC argues that the corporate opportunity issue is still a live issue because it concerns the matter of what is an appropriate remedy. CVC cites the Court of Appeals as stating that "[w]e believe [CVC's corporate] opportunity argument more relevant to the remedy issue than to whether a breach of fiduciary duty occurred." 160 F.3d at 988.

CVC's partial quote of the Court of Appeals' discussion is somewhat misleading. A more complete quote reads as follows:

> CVC contends that *Brown* is distinguishable because Papercraft was not in a financial or legal position to purchase the notes and because the members of the Committee must have been well aware that a market existed in Papercraft debt. It necessarily follows, according to CVC, that neither could have been injured by its purchases. We believe this argument more relevant to the remedy issue than to whether a breach of fiduciary duty occurred. That duty required that it share everything that it knew with Papercraft's board and the Committee before commencing its purchases. **Its failure to do so would alone support a subordination depriving it of its profits from the note transactions.**

160 F.3d at 988 (emphasis added). The Court went on to conclude that "[a]t a minimum, the remedy here should deprive CVC of its profits on the purchase of the notes. . . . Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles." *Id.* at 991. As previously noted, therefore, the Court held that "[o]n remand, the bankruptcy court should consider whether the record supports the proposition that the non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan." *Id.* at 992.

Thus, as the Court of Appeals makes quite clear, CVC's conduct in breaching its fiduciary duty requires at a minimum the remedy of disgorgement of CVC's profit, regardless of whether any one else could have or would have purchased the claims in lieu of CVC. The Court goes on to explain that CVC's conduct in pursuing its own interest in advocating a competing plan may have caused harm to creditors in the nature of delay in plan confirmation. Indeed, harm caused by CVC's attempt to control the reorganization was the only matter the Bankruptcy Court was to consider on remand. This type of harm, which the Bankruptcy Court properly found was caused by CVC's conduct, is distinct from the harm caused by a usurpation of a corporate opportunity. In other words, it was CVC's self-dealing and related conduct in advocating a competing plan that caused harm in the form of delay regardless of whether any one else could have purchased the claims.

Accordingly, the Bankruptcy Court's decision to reject CVC's corporate opportunity argument will be affirmed.

On a final note, we think it necessary to address a troubling comment contained in CVC's brief. CVC states:

> In its Final Order, however, **the Bankruptcy Court, apparently straining to find a basis to subordinate CVC's claim beyond any factual justification,** asserted that CVC's request for financial information — most of which were made before the bankruptcy proceeding was commenced — somehow delayed the filing of the disclosure statement by diverting Debtor's resources from preparation of the disclosure statement.

CVC's Br. (Doc. No. 2) pp. 20-21 (emphasis added). CVC's comment could be interpreted as a thinly veiled attack on the Bankruptcy Judge's integrity and/or impartiality. We want to make it clear that based on our review of the extensive record and court opinions in this case, we believe that the

Bankruptcy Judge has at all times acted impartially and fairly to all parties concerned. If CVC reasonably believes that the Bankruptcy Judge is unfairly biased against it, there is a proper way to address that concern. Such allegation must, of course, have evidentiary support other than the fact that the Judge's rulings have not gone its way. *See* Fed. R. Civ. P. 11. Otherwise, CVC's comment, standing alone, might be taken by the reviewing court as an attack on a distinguished judge based on nothing more than CVC's displeasure with her rulings. Needless to say, pouting of this sort is not persuasive and does nothing to further CVC's position on the legal issues.

For the foregoing reasons, **IT IS HEREBY ORDERED** that the April 20, 2000 and September 21, 2000 orders of the Bankruptcy Court are **REVERSED** as to the subordination of CVC's claims for lost interest income in the amount of $956,250. The balance of the April 20, 2000 and September 21, 2000 orders are **AFFIRMED. IT IS FURTHER ORDERED** that this case is **REMANDED** to the Bankruptcy Court for the entry of an order subordinating CVC's claims for lost interest income in the amount of $50,123.45.

**SO ORDERED** this 20 day of February, 2002.

The Clerk is directed to mark Civil Action No. 00-2181 **CLOSED**.

/s/ Robert J. Cindrich

ROBERT J. CINDRICH
United States District Judge

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**UNITED STATES BANKRUPTCY COURT**
**WESTERN DISTRICT OF PENNSYLVANIA**

| | |
|---|---|
| IN RE: | |
| PAPERCRAFT CORPORATION, | |
| A Pennsylvania corporation, | Bankruptcy No.: |
| Debtor, | 91-20903 JKF |
| COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS and COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT, | Adversary No. 91-2642 |
| | Chapter 11 |
| | Civil Action No. 02-____ |
| | (Related to District Court Civil Action No. 00-2181) |
| Plaintiff/Appellee, | |
| V. | |
| CITICORP VENTURE CAPITAL, LTD., a New York Corporation, | |
| Defendant/Appellant | |

**DESIGNATION OF RECORD OF APPELLANT CITICORP VENTURE CAPITAL, LTD.**

Citicorp Venture Capital, Ltd. ("CVC") by and through its undersigned counsel, files this Designation of Record on Appeal. This Designation of Record is identical to the Designation of Record submitted to the Bankruptcy Court on

October 23, 2000, regarding the Appeal to the District Court filed at Civil Action No. 00-2181. The only addition to this Designation is set forth in Part E hereof.

**DESIGNATION OF RECORD.**

A. Adversary Case Proceeding 91-2642

| Docket No. | Description[1] |
|---|---|
| 1. | 1. "Complaint" |
| 7. | 2. "Answer by Citicorp Venture Capital, Ltd" |
| 12 | 3. "Amded Ans. of Citicorp Venture Capital, Ltd., to Cmplt." |
| 49 | 4. "Muqaddam taken by pltff on 2/12/92 at 10:20am" |
| 50 | 5. "Copy of deposition of Citicorp Venture Capital Corp, Ltd. By M. Saleem Muquaddam taken by pltff on 2/14/92 at 9:30 am." |
| 51 | 6. "Copy of deposition of Citicorp Venture Capital, Ltd by Saleem Muqaddam taken by pltff on 2/24/92 at 9:30 am." |
| 52 | 7. "Pltff's exhs 32-51 to the deposition of M. Saleem Muqaddam on 4/14/92." |
| 53 | 8. "Copy of cont'd deposition of M. Saleem Muqaddam taken by pltff purs to notice & stip on 4/14/92 at 10:00 am." |
| 54 | 9. "Deposition of Frank T. Kane of 4/10.92." |

[1] Quotations are placed around each description since the description is verbatim from the applicable docket.

| | | |
|---|---|---|
| 55 | 10. | "Deposition of Frank T. Kane of 4/10.92." |
| 57 | 11. | "Deft's Memo of Law in Opposition to Plfts Mtn for Prtl Summary Jdgmt." |
| 58 | 12. | "Answer by Deft Citi Ccorp Venture Capital, LTD to Mtn for Prtl Summary Jdgmt & Resp to Pltfs Req. for Judicial Notice." |
| 62 | 13. | "Transcript of Deposition held 4/15/92 of William Comfort." |
| 66 | 14. | "Transcript of Hrg Held 6/24/92 on Prtl Summary Judgmt." |
| 67 | 15. | "Transcript of Hrg Held 3/4/92 on Tele conf. call." |
| 69 | 16. | "Transcript of Hearing Held on 1/21/93" [1/21/92] |
| 103 | 17. | "Defendant's Exhibits 1 thru 14." |
| 104 | 18. | "Defendant's Exhibits 15 thru 17." |
| 105 | 19. | "Defendant's Exhibits 26 thru 80." |
| 106 | 20. | "Defendant's Exhibits 18 thru 25." |
| 122 | 21. | "Pre-Trial Evidentiary Submission Filed by Defendant Citicorp Venture Capital, Ltd." |
| 141 | 22. | "Letter dated 12/9/94 Filed by Philip Beard asking the court to re-examine its Opinion and Order on Summary Judgment and proceed to make findings of fact and conclusions of law on both the Objection to the Allowance of Claims and Equitable Subordination based on the complete trial record. *(cont'd)* |

They have not been authorized by the Committee to consent to the Court proceeding on that basis."

144 23. "Order entered 12/22/94 that all parties having consented to the Court reviewing the entire complaint on the merits, and no party having advised of a need to reopen the record to present additional evidence, IT IS ordered that the evidentiary record is closed and that upon receipt of the briefs and post trial papers, the Court will take the matter under advisement. cm: all parties in interest"

145 24. "Post-Trial Submission Filed by Defendant Citicorp Venture Capital, Ltd A Del"

171 25. "Final Memorandum Opinion & Order dated 8/7/97 By Judge Robert J. Cindrich Re: [147-1] Judgment Order dated 10/12/95. The order is reversed in so far as it adopted a per se rule which limits an insider's allowed claim to his or her purchase price with recovery being gauged to such reduced claim when the insider purchases the claim against an insolvent debtor without disclosing his or her identity and connection with the debtor. This case is remanded to the Bankruptcy Court for further consideration as set forth in the accompanying memorandum opinion. (Civil Action#95-1886 and # 95-1872)"

| | | |
|---|---|---|
| 178 | 26. | "Final Order by Judge Cindrich signed 1/6/99 remanding matter back to the Bankruptcy Case re: [147-1} Judgment Order Civil Action #95-1872 and 95-1886) |
| 184 | 27. | "Transcript of Hearing Held on 4/5/99" |
| 186 | 28. | "Opening Brief by Defendant Citicorp Venture Capital, Ltd. [1-1] on Remand From Court of Appeals for the Third Circuit." |
| 187 | 29. | "Appendix of Opening Brief by Defendant Citicorp Venture Capital, Ltd. [1-1] on Remand From Court of Appeals for the Third Circuit." |
| 189 | 30. | "Appendix to Opening Brief of Committee of Unsecured Claims and Committee of Creditors holding Unsecured Claims as Estate Representative of Papercraft Corp. on Remand from Court of Appeals for the Third Circuit." |
| 190 | 31. | Reply Brief by Defendant Citicorp Venture Capital Ltd. on Remand from Court of Appeals for the Third Circuit." |
| 192 | 32. | "Order dated 7/8/99 stating that on or before 9/7/99, Citicorp Venture Capital, Ltd. shall file and serve a supplemental brief. On or before 10/15/99, the Unsecured Creditors Committee shall file and serve a reply brief. Not later than 10/20/99, CVC shall file and serve a rebuttal brief." |
| 193 | 33. | "Transcript of Hearing Held on 7/799" |

| | | |
|---|---|---|
| 196 | 34. | "Transcript of Hearing Held on 6/14/99" |
| 197 | 35. | "Supplemental Remand Memorandum [190-1] by Defendant Citicorp Venture Capital, Ltd. by Defendant Corp Venture Capital, Ltd." |
| 198 | 36. | "Supplemental Remand Memorandum [197-1] by Defendant Citicorp Venture Capital, Ltd. by Defendant Citicorp Venture Capital, Ltd" |
| 201 | 37. | "Reply Brief by Defendant Citicorp Venture Capital, Ltd. To Supplemental Brief of Committee." |
| 208 | 38. | "Memorandum Opinion and Interim Order signed 4/20/00 stating that the creditors' committee shall file and serve: 1) a summary of professional fees and expenses incurred in relation to this adversary not included in the $1,248,000 administrative fees; 2). A statement of post-confirmation US Trustee Fees. On or before 6/15/00, CVC shall file and serve objections to the professional fees and expenses. If Objections are filed, counsel to the Committee and CVC shall meet and confer by 6/27/00. If an agreement is reached, a stipulation shall be filed by 7/10/00. If no stipulation is filed by 7/10/00, a hearing will be held on 7/12/00 at 1:30 in Courtroom A." |

| | | |
|---|---|---|
| 209 | 39. | "Plaintiff Com of Creds Hldg Unsec. Claims Summary of Post-confirmation Date Fees and Expenses Incurred and/or paid to the United States Trustee and Professionals in connection with the adversary proceeding." |
| 211 | 40. | "Response in the Nature of an Objection by Defendant Citicorp Venture Capital Ltd. To [209-1] The Creditors' Committee's Summary of Post-Confirmation Date Fees and Expenses Incurred and/or Paid to: (1) U.S. Trustee; and (2) Professionals in Connection with this Adversary Proceeding." |
| 212 | 41. | "Appendix of Citicorp Venture Capital Ltd. on Remand from Court of Appeals for the Third Circuit." |
| 213 | 42. | "Letter Filed by U.S. Trustee's Office responding the request of 7/12/00. The fees that were accrued and paid from confirmation were $7,750.00." |
| 216 | 43. | "Transcript of Hearing Held on 7/12/00" |
| 217 | 44. | "Memorandum Opinion and Final Order signed 9/21/00 stating: CVC's claim shall be equitably subordinated in an amount sufficient to afford CVC an unsubordinated distribution of $5,370,168.73 and a subordinated distribution of $5,183,373.15." |
| | 45. | Copy of Adversary proceeding docket 91-2642 |

B. Bankruptcy Case No. 91-20903-JKF

1. Copy of Bankruptcy case docket 91-20903 — JKF

C. United States District Court, Case No. 95-1872- and 95-1886

1. Briefs filed by Citicorp Venture Capital, LTD

2 A. Appellant/Cross Appellee's Reply Brief in Support of Appeal of Order Limiting Recovery of Purchased Claims.

5 B. Appellant/Cross-Appellee's Reply Brief in Support of Appeal of Order Limiting Recovery on Purchased Claims

D. Third Circuit Court of Appeals, Case No. 97-3518 & 97-3591

1. Opinion dated November 24, 1998.

E. United States District Court, Case No. 00-2181

1. Briefs filed by Citicorp Venture Capital, Ltd.

A. Appellant's Opening Brief in Support of Appeal 11/21/00.

B. Reply Brief of Appellant 12/18/00.

C. Memorandum Opinion of Hon. Robert J. Cindrich, dated February 20, 2002.

Dated: March 21, 2002

Respectfully submitted

By: /s/ Amy M. Tonti

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**IN THE UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA**

| | |
|---|---|
| IN RE: | ) |
| PAPERCRAFT CORPORATION | ) |
| a Pennsylvania Corporation | ) |
| Debtor(s) | ) Bankruptcy No. 91-20903 JKF |
| COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS | ) Chapter 11 |
| AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT | ) Adversary No. 91-2642 |
| Plaintiff(s) | ) On second remand from the U.S. District Court, Western District of Pennsylvania |
| v. | ) |
| CITICORP VENTURE CAPITAL, LTD. | ) |
| a New York Corporation | ) |
| Defendant(s) | ) |

ORDER

AND NOW, to wit, this 27 day of February, 2002, in accord with the Memorandum Order of the Honorable Robert J. Cindrich dated February 20, 2002, at Civil Action No. 00-2181, IT IS ORDERED that this Court's Order dated September 21, 2000, is amended in full as follows:

The amount of the unsubordinated distribution of Citicorp Venture Capital, Ltd. (CVC) previously found by this Court to be in the amount of $5,370,168.73 is increased by an additional $906,126.55 for a total of $6,276,295.28. CVC's

subordinated distribution, previously found by this court to be in the amount of $5,183,373.15 is decreased by the same $906,126.55, thereby affording CVC a subordinated distribution in the amount of $4,277,246.60. The amendment to this Order is in accord with Judge Cindrich's Memorandum Order of February 20, 2002, that lost interest income should be subordinated in the amount of $50,123.45 rather than in the amount of $956,250.00 as previously ordered by this court.

The Clerk shall close this adversary.

/s/ Judith K. Fitzgerald
Judith K. Fitzgerald
Chief U.S. Bankruptcy Judge

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**LEXSEE 2000 Bankr. LEXIS 1063**

**IN RE: PAPERCRAFT CORPORATION a Pennsylvania corporation, Debtor(s); COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT, Plaintiff(s) v. CITICORP VENTURE CAPITAL, LTD. a New York corporation, Defendant(s)**

**Bankruptcy No. 91-20903 JKF, Chapter 11, Adversary No. 91-2642**

**UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA**

***253 B.R. 385; 2000 Bankr. LEXIS 1063***

**September 21, 2000, Decided**

**COUNSEL:**

George M. Cheever, Esquire, for Debtor.

Stephan M. Ray, Esquire, K. John Shaffer, Esquire, and Philip E. Beard, Esquire, for Creditors' Committee.

Amy M. Tonti, Esquire, Lawrence J. Slattery, Esquire, and Jeanette H. Ho, Esquire, for Citicorp Venture Capital, Ltd.

United States Trustee, Pittsburgh, PA.

**JUDGES:**

Judith K. Fitzgerald, Chief Bankruptcy Judge.

**OPINION BY:**

Judith K. Fitzgerald

**OPINION:**

**MEMORANDUM OPINION**[2]

The matter before me is Citicorp Venture Capital, Ltd.'s ("CVC") objection to the Creditors' Committee's post-confirmation fees and expenses submitted pursuant to my Order of April 20, 2000. That Order required the Creditors' Committee to file

> (1) a summary of all professional fees and expenses incurred in relation to this adversary that are not included in the $1,248,000 administrative fees incurred during the four-month plan confirmation delay;
>
> (2) a statement of post-confirmation U.S. Trustee fees incurred and/or paid through the date of this Order.

The Creditors' Committee filed its "Summary of Post-Confirmation Date Fees and Expenses Incurred and/or Paid to: (1) United States Trustee; and (2) Professionals in Connection With This Adversary Proceeding" ("Summary of Fees") on May 17, 2000. CVC filed its "Response . . . in the Nature of an Objection" ("CVC's Response") on June 15, 2000. I heard argument on July 12, 2000.

The Creditors' Committee requests that CVC's claims be subordinated by the following amounts:

> 1. The profit on CVC's illegal claims trading, in the amount of $5,434,058.12 . . .
>
> 2. The additional administrative expenses incurred by the Papercraft estate during the four-month delay in confirmation of the BDK Plan, in the amount of $1,248,000 . . .

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[2] The court's jurisdiction was not at issue. This Memorandum Opinion constitutes our findings of fact and conclusions of law.

> 3. Interest and dividends lost by creditors during the four-month delay in confirmation of the BDK Plan, in the amount of $956,250 . . .
>
> 4. United States Trustee fees incurred and/or paid by the Papercraft estate from the date of confirmation through May 2, 2000, in the amount of $16,900 . . .
>
> 5. Additional professional fees and expenses incurred and/or paid by the Papercraft estate or BDK from February 14, 1992, through April 30, 2000, in the amount of $2,974,373.15 . . . and[3]
>
> 6. Such other and further relief as this Court deems appropriate.

Summary of Fees, Adv. Docket No. 209, at 7.

The parties agreed at the hearing on July 12, 2000, that the amount of U.S. Trustee fees at issue is $4,750, not the $16,900 originally claimed. I will enter an order reflecting the parties' agreement on this point.

Many of CVC's objections merely restate the issues that were litigated, appealed, and dealt with by me on remand. However, in light of the parties' most recent submissions, the following points require additional explanation.[4]

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[3] Since the Creditors' Committee filed its Summary of Fees the 26th Report on Compensation Paid and Expenses Reimbursed to Professionals has been filed showing a total of post-confirmation professional fees in the amount of $3,282,859.76. Adv. Docket No. 951.

[4] CVC argues at note 1 of its Response to the Creditors' Committee Summary of Post-Confirmation Fees and Expenses that it has not profited and that the "imaginary paper profit" is based on a "hypothetical estimated intrinsic value" which did not reflect the market value of the BDK units. At trial and again in my Memorandum Opinion of April 20, 2000, I rejected CVC's method of valuation of the BDK units. Its renewed argument in this respect is without merit.

CVC also argues that it should be paid its claim in full because if CVC had not bought claims, its share would have gone to the selling

**Delay in Confirmation**

CVC cites to the transcript of a hearing before me held on August 29, 1991,[5] in support of its argument that I granted an extension of the exclusive period to file the plan of reorganization based on the existence of pending litigation with Debtor's landlord, Second Pennsylvania Real Estate Corporation ("Second Pennsylvania"). According to CVC, in light of the Second Pennsylvania litigation, the earliest the plan could have been confirmed was the last week of November of 1991, less than two months before the actual confirmation date of January 21, 1992. See CVC's Response, Adv. Docket. No. 211, at notes 6 through 10 and accompanying text. However, at the August 1991 hearing, in addressing the existence of the Second Pennsylvania litigation and its effect on the progress of the case, counsel for the Debtor stated that the Debtor did "not intend to be paralyzed by the prospect of litigation with Second Pennsylvania", Transcript of August 29, 1991, at 5, and "assured the Court that one way or another a plan will be filed by September 18 [1991]." Id. at 4. Nonetheless, I extended the exclusive period one week, from September 18 to September 25. This Adversary complaint was filed a month later, on October 31, 1991.

At the trial on this matter, on November 15, 1994, I noted that the plan could have been confirmed despite the problem with Second Pennsylvania. Transcript of November 15, 1994, Adv. Docket No. 159, at 84.[6] Furthermore, Kenneth Klee,

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noteholders anyway and, therefore, creditors were not harmed. This argument is without merit inasmuch as CVC breached its fiduciary duties in purchasing the claims and is precluded from benefitting as a result of its conduct.

[5] This transcript is reprinted in Volume 2 of CVC's Appendix to its brief on remand as Exhibit 3.

[6] The cover page of this transcript incorrectly reads "November 15, 1995".

formerly of Stutman, Treister & Glatt, lead counsel for the Creditors' Committee in the Adversary, testified that, based on entries in Debtor's counsel's fee application which indicated the amount of time spent on Second Pennsylvania litigation and the disclosure statement between March or April and October of 1991, the delay in preparing the disclosure statement in this case was not the result of the Second Pennsylvania litigation. Transcript of November 15, 1994, at 84, 86-90.[7]

There also existed an issue regarding American Technical Industries, Inc. ("ATI") but it was addressed in the BDK plan filed shortly after the case was commenced. See *In re Papercraft Corporation, 187 B.R. 486, 501 (Bankr.W.D.Pa. 1995),* where I found that consideration had been given to the ATI issue prepetition and, therefore, this was not cause for the delay in filing the disclosure statement. Based on the record, I concluded that the Second Pennsylvania and ATI issues did not account for the delay in filing the disclosure statement in this case. No other explanation for the delay was offered. The only other event occurring at the time was the undisclosed purchase of notes by CVC in breach of its fiduciary duty.[8] "There is nothing unusual about a court finding credible one plausible explanation of the significance of documentary evidence." *Citicorp Venture*

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[7] See note 5, supra.

[8] I note that at the August, 1991, hearing neither Debtor nor CVC disclosed CVC's efforts to acquire financial information and its trading in claims. Thus, the court was not given the complete picture of the circumstances that caused delay at that time. As I found in my opinion of April 20, 2000, Debtor's filing of competing plans, when a pre-negotiated plan was filed at the outset of the case, is unusual. The fair inference from the events is that CVC used its status on Debtor's board of directors and on Debtor's affiliates' boards of directors, together with its then newly acquired vote blocking position for the BDK plan to influence Debtor to file the CVC plan, thereby delaying the entire process. *In re Papercraft Corporation, 247 B.R. 625, 629-30 (Bankr.W.D.Pa. 2000).*

*Capital v. Committee of Creditors Holding Unsecured Claims, 160 F.3d 982, 989 n.5 (3d Cir. 1998).* The evidence amply supports the conclusion that the delay was the result of CVC's claims purchasing activities.[9]

**Amount of Interest**

I have reexamined the evidence with respect to the amount of interest attributable to the delay and conclude that Mr. Victor's assessment of lost interest income in the amount of $956,250 is appropriate. Mr. Victor's Declaration provides that

> In connection with the BDK Plan, creditors received new debt securities with a face value of $33,750,000 with an annual interest rate on the debt securities of 8.5%. On a monthly basis, this translates into $239,062 of lost income incurred as a result of the delay in confirming the BDK Plan. Again, assuming a four month delay due to the actions of CVC, the cost to creditors in the aggregate is $956,250.

Victor Declaration, supra, at P 26b. The calculation is:

$33,750,000 x .085% = $2,868,750 interest per year

$2,868,750/12 months = $239,062.50 interest per month

$239,062.50 x 4 months = $956,250

The Creditors' Committee argued at the July 12, 2000, hearing that Mr. Victor's calculation of lost income was correct because the securities from which the interest

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[9] After the BDK disclosure statement was approved, the plan confirmation hearing was set but CVC used its new position as a noteholder to assert objections to the plan, despite having participated in approving it prepetition. Although CVC's assertion of objections to the plan did not necessarily cause a delay between the filing of the disclosure statement and confirmation of the plan, its conduct led to increased professional fees in this case because its objections had to be addressed and plan language changed to reflect a compromise reached by the parties.

stemmed have not been issued as the result of this litigation with CVC. The four month period Mr. Victor referred to occurred preconfirmation and is the period in which the plan was not confirmed but should have been. The order confirming the plan provides that "The BDK Notes shall accrue interest from the Effective Date and shall mature 10 years from the Effective Date." Order Confirming Plan at 10, P 12.[10] The plan fixes the term in which the notes will be held at interest and not distributed to creditors. Thus, but for CVC's conduct, the plan could have been confirmed at least four months before it was, the securities would have been issued four months earlier, the interest would have begun and the distribution of principle and interest would have been made four months before it now will be. Hence, creditors have lost the ability to use their money from the distribution for four months.

CVC argues that what was "lost" was only interest on the $956,250 because the principle investment will earn the same amount of interest over the ten-year investment term. At first blush, CVC's argument seems meritorious. Upon further analysis, however, it fails. The investment term itself is delayed in implementation for four months which, once expired, cannot be recaptured. Time lost cannot be regained. Under the Creditors' Committee's analysis, the four month period is treated as a preconfirmation delay. Under CVC's analysis, it is a post-confirmation delay. Under

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[10] The Plan defines "Effective Date" as "the date on which this Plan shall take effect, as provided in sections 6.19 and 12.2 of this Plan. . .." BDK Plan at 5. Section 6.19 refers to mergers that would take place before the Effective Date. Section 12.2 states that "Except as provided in section 6.19 or ARTICLE XI, paragraph p., the Effective date . . . shall occur . . . on the first Business Day on which no stay of the Confirmation Order is in effect that is more than ten (10) days . . . after the Confirmation Date" and the mergers. Article XI concerns retention of jurisdiction to, *inter alia*, determine rights to distribution pursuant to the Plan (P d) and to resolve any disputes concerning implementation of the Plan (P f).

either analysis, the $33,750,000 principle earns $956,250 in simple interest at 8.5 percent over four months. Because the creditors will be forever deprived of the use of their funds for four months as the result of CVC's conduct, they are entitled to recoup the 8.5 percent rate of return utilized in the plan as the measure of lost earnings.[11] CVC's claim will be equitably subordinated by the $956,250.

**Amount of Fees and Expenses**

CVC makes various arguments as to why the fees and expenses itemized by the Creditors' Committee should be reduced, if considered at all, on the grounds that not all of them can be attributed to CVC's conduct. I find, however, that none of the amount at issue incurred during the pre-confirmation delay or associated with the Adversary would have been incurred but for CVC's conduct. Therefore, all of it is attributable to CVC and CVC's claim is to be sub-ordinated by that amount. Accordingly, CVC's argument for reduction in the fees and expenses is rejected.

**American Rule**

CVC also argues that the subordination of its claim should not include the amount of the Creditors' Committee's fees because under the American rule litigants are to bear their own attorneys' fees absent statutory or contractual authorization. See *Davies v. Waxman, 1989 U.S. Dist. LEXIS 6561,* *6, *1989 WL 63235* (M.D.L. No. 745, CIV. A. Nos. 86-6508, 86-7516)(E.D. Pa. 1989) at *5. See also *Hall v. Cole, 412 U.S. 1, 4, 93 S. Ct. 1943, 1945, 36 L. Ed. 2d 702 (1973).* The American Rule does not apply to the

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[11] In reality, the creditors will also lose interest on the $956,250 interest earnings and will be forever deprived of the opportunity to use their principle and interest for four months. Lost opportunity damages, however, must be nonspeculative. See *Hershock v. Fiascki, 1992 U.S. Dist. LEXIS 9305, 1992 WL 164739 (E.D.Pa. 1992).* I cannot assess what those damages will be.

circumstances at issue. The Creditors' Committee isn't asking for payment of attorneys' fees as such. Rather, the fees at issue depleted funds otherwise available to creditors of this estate due to CVC's conduct in breach of its fiduciary duty. That is, CVC's conduct caused the amount available to the estate to pay creditors to be reduced. To assure the creditors the distribution they should have received but for CVC's conduct, I find it necessary to restore the fund by subordinating CVC's share of distribution by the amount of fees and expenses incurred by professionals who are to be paid from estate assets that would not have been incurred but for CVC's breach of its fiduciary duty.

**Conclusion**

In accordance with the foregoing and the opinion of the Court of Appeals, CVC's maximum recovery cannot exceed $10,553,541.88.[12] Based on the foregoing and using the $10,553,541.88 as the starting point, its recovery is further subordinated by lost interest income of $956,250, administrative costs of $1,248,000 incurred during the delay in plan confirmation, fees and costs through April 30, 2000, of $2,974,373.15, and post-confirmation U.S. Trustee fees of $4,750. These amounts total $5,183,373.15. Thus, CVC's unsubordinated distribution will be $5,370,168.73.

An appropriate order will be entered.

Judith K. Fitzgerald

Chief Bankruptcy Judge

DATED: September 21, 2000

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[12] CVC's claim based on the face value of its purchases was $60,849,299.10 and, if nothing was subordinated, its recovery under the confirmed plan would be $15,989,676.56.

**FINAL ORDER**

AND NOW, to-wit, this **21st** day of **September, 2000**, for the reasons expressed in the foregoing Memorandum Opinion, and the Memorandum Opinion and Order of April 20, 2000, it is **ORDERED, ADJUDGED, and DECREED** that CVC's claim shall be equitably subordinated in an amount sufficient to afford CVC an unsubordinated distribution of $5,370,168.73 and a subordinated distribution of $5,183,373.15.

Judith K. Fitzgerald

Chief Bankruptcy Judge

**LEXSEE 2000 Bankr. LEXIS 420**

**IN RE: PAPERCRAFT CORPORATION, Debtor(s); COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS and COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT, Plaintiff(s) v. CITICORP VENTURE CAPITAL, LTD. a New York corporation, Defendant(s)**

**Bankruptcy No. 91-20903 JKF, Chapter 11, Adversary No. 91-2642**

**UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA**

***247 B.R. 625; 2000 Bankr. LEXIS 420; 36 Bankr. Ct. Dec. 7***

**April 20, 2000, Decided**

**CASE SUMMARY**

**COUNSEL:**

Stephan M. Ray, Esquire, and Philip E. Beard, Esquire, for Committee.

Amy Tonti, Esquire, Jeffrey Deller, Esquire, and Lawrence J. Slattery, Esquire, for Citicorp Venture Capital, Ltd.

United States Trustee, Pittsburgh, PA.

**JUDGES:**

Judith K. Fitzgerald, Chief Bankruptcy Judge.

**OPINION BY:**

Judith K. Fitzgerald

**OPINION:**

## MEMORANDUM OPINION[1]

### Introduction

This matter is before me on remand from the Court of Appeals. The facts have been detailed in my earlier opinion, *187 B.R. 486 (Bankr. W.D.Pa. 1995),* the District Court's opinion, *211 B.R. 813 (W.D. Pa. 1997),* and the Court of Appeals' opinion, *160 F.3d 982 (3d Cir. 1998),* and will not be repeated here except to note that Citicorp Venture Capital ("CVC"), an insider of the Debtor owning a 28 percent equity interest in Debtor's parent company, bought notes from creditors of Debtor through brokers without disclosing its identity as a fiduciary and insider of the Debtor. My findings of fact were upheld on appeal by the District Court and the Court of Appeals. The District Court, however, reversed with respect to the remedy imposed. The Court of Appeals affirmed the District Court. The matter is before me now on remand for consideration of the appropriate remedy in light of the harm visited by CVC's conduct.

This court ruled that the amount of CVC's claim would be limited to the amount it paid for the claims, not to the face value of the notes purchased which constituted the claims. I also held that distribution to CVC on its reduced claim would be limited to the percentage distribution provided in Debtor's plan, as applied to the allowed claim. In re- *Papercraft Corporation, 187 B.R. 486, 491 (Bankr.W.D.Pa. 1995).*

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[1] The court's jurisdiction was not at issue. This Memorandum Opinion constitutes my findings of fact and conclusions of law. I incorporate the findings made on the record on July 7, 1999, at the hearing on arguments to determine whether the record should be reopened on remand. I conclude that there is no need to reopen the record inasmuch as the parties were afforded the opportunity to litigate all issues at trial. Moreover, the record contains sufficient evidence of quantifiable harm to subordinate CVC's claim beyond simply removing its profit, as is explained in the Opinion proper.

The District Court, while agreeing that CVC should not profit from its conduct, reversed on the basis that I had created a per se rule to apply to all insider trading undertaken without disclosure and had no authority to do so. The District Court noted that § 510 of the Bankruptcy Code exists to address inequitable conduct by insiders and that a per se rule "removes the principles of equity and applies instead a universal penalty for any instance of noncompliance." *In re Papercraft Corporation, 211 B.R. 813, 822-24 (W.D. Pa. 1997).*

The District Court held that my finding of injury to creditors or unfair advantage to CVC based on its inequitable conduct was supported by the evidence and not clearly erroneous. The District Court instructed me to make findings as to the appropriate amount of the limitation on CVC's claim, finding that I did not sufficiently support the amount of the limitation I imposed on CVC's recovery and did not reconcile the limitation with the principles of equity. The District Court did

> not conclude . . ., however, that CVC's claims may not be subordinated by such an amount but only that any amount of subordination beyond the limitation of CVC's recovery to the amount paid for such claims should be supported by factual findings and reconciled with the principles of equity.

*In re Papercraft Corporation, 211 B.R. 813, 827 (W.D.Pa. 1997).*

The Court of Appeals held that

(1) my findings of inequitable conduct were not clearly erroneous. In fact, the Court of Appeals held that those "findings [of fact] make this a paradigm case of inequitable conduct by a fiduciary as that concept has

been developed in the case law. . . .", *Citicorp Venture Capital v. Committee of Creditors Holding Unsecured Claims, 160 F.3d 982, 987 (3d Cir. 1998);*

(2) the injury or unfair advantage that was found to exist by the bankruptcy and district courts was sufficient to justify equitable subordination of CVC's claim; and

(3) equitable subordination as a remedy is consistent with the Bankruptcy Code.

The Court of Appeals agreed with the District Court that CVC should be deprived of its profit and "that can be accomplished by subordinating CVC's claim under § 510(c) to the extent necessary in order to limit its recovery to the purchase price of the notes." *160 F.3d at 991.* The Court further stated, however, that it was not requiring "a specific price tag" to justify every remedy beyond disgorgement of profit, id., and that further subordination had to be "supported by findings that justify the remedy chosen by reference to equitable principles. . . ." so that an appellate court can determine the proportionality of the remedy to the injury suffered by those benefitting from the subordination. Id.

The Court of Appeals disagreed with the District Court's conclusions that § 510(c) is necessarily the exclusive remedy available to me and disagreed that I am without authority to fashion a disallowance remedy. *160 F.3d at 988, n.7,* citing *Pepper v. Litton, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939),* a pre-Code case.

However, the Court of Appeals required that the

bankruptcy court should . . . attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the remedy to the injury that has been suffered by those who will benefit from the subordination. If that is not possible, the court should specifically so find.

*160 F.3d at 991.* The Court held that injury to the selling noteholders was not a factor to be considered. It also noted the existence of evidence that would support a finding that the nonselling noteholders were injured by CVC's conduct which caused the delay in the confirmation of the plan.

With respect to the elements of equitable subordination, the Court of Appeals recited:

> Before ordering equitable subordination, most courts have required a showing involving three elements: (1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy code.

*Citicorp Venture Capital v. Committee of Creditors Holding Unsecured Claims, 160 F.3d 982, 986-87 (3d Cir. 1998),* citing *U.S. v. Noland, 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748 (1996).*[2] In my opinion of October 12, 1995, I found the first two elements to have been satisfied but withheld subordination on the third element because of the form of per se remedy I imposed. In this opinion, therefore, I address the evidence to determine whether subordination is consistent with the Bankruptcy Code.

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[2] *11 U.S.C. § 510*(c) provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may —
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

Only subsection (1) is applicable in the matter before us.

An examination of the evidence and the Court of Appeals' decision in this case leaves no question that subordination of CVC's claim is consistent with the Bankruptcy Code and appropriate under the facts of this case. Subordination to the extent that it permits CVC to recover no more than the amount it paid for its claims is the minimum remedy to be imposed. The Court of Appeals held that CVC's fiduciary duty required it to "share everything it knew with Papercraft's board and the Committee before commencing its purchases" and that "its failure to do so would alone support a subordination depriving it of its profit from the note transactions." *160 F.3d at 988.* At this point my task is to identify specific harm, if any, supporting a remedy more drastic than subordination of the claim beyond removing all profit.

The Court of Appeals opined that where the harm to be redressed is not quantifiable, "it should not redound to the benefit of the wrongdoer" but the court "should, however, attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding a proportionality of the remedy to the injury that has been suffered by those who will benefit from this subordination", if possible. *160 F.3d at 991.*

**Discussion**

On the issue of what facts support equitable subordination and what harm is quantifiable, I find from the trial record as supplemented by the court's docket, of which I take judicial notice, that CVC's conduct resulted in three categories of economic harm to non-selling noteholder creditors. The first two encompass (a) the delay in confirming the plan which resulted in harm that is quantifiable in terms of dollars and (b) the uncertainty over the amount of CVC's claim distribution thereon that is not easily quantifiable. The third relates to the filing of this adversary which, through the appellate and remand process, has created a delay in fully

implementing the confirmed plan of over four years from the date of my initial opinion (October 12, 1995) to today and of eight years since this adversary was filed on October 31, 1991. At the very least, while this adversary has been pursued through three courts and five proceedings,[3] this delay has caused Debtor to incur professional fees and expenses and additional U.S. Trustee quarterly fees which must be paid until the case is, *inter alia*, closed. See *28 U.S.C. § 1930*(a)(6); *United States Trustee v. Gryphon at the Stone Mansion, Inc., 166 F.3d 552, 554 (3d Cir. 1999).*

1. Delay in Plan Confirmation

In my 1995 opinion I stated that "there was no evidence that CVC engaged in conduct designed to delay the plan process", *187 B.R. at 501,* and that "there was insufficient evidence to establish that CVC purchased claims with the intent to harm Debtor or defraud its creditors." Id. Notwithstanding lack of evidence that CVC's INTENT was to delay the process in order to harm creditors, there was more than enough evidence to establish that CVC's conduct did, in fact, delay it and that CVC's intent was to benefit itself over and above other creditors to whom it owed a fiduciary duty not to self-deal. In requiring Debtor to furnish the financial information described below, CVC caused Debtor to divert its resources from reorganization activities it

[3] The motion for summary judgment, two opinions by this court (excluding this one) and a trial, two appeals, and the hearing after remand in which the parties presented arguments to determine whether the record should be reopened in light of the Court of Appeals' opinion. After argument and consideration of the parties' briefs and the record, I conclude that the record need not be reopened. All of this, however, has resulted in increased attorneys' fees and costs and increased post-confirmation U.S. Trustee fees. In addition to litigation expenses, professional fees have been increased in fulfilling this court's requirement that status reports be filed during the pendency of the appeals.

should have undertaken, i.e., preparing the disclosure statement that was to accompany what is now called the BDK plan of reorganization filed at the outset of the case.

When a chapter 11 plan which has been approved by creditors prepetition is filed early in the case, a disclosure statement explaining the basis for the plan should be filed with that plan or shortly thereafter. In fact, the record shows that this was the expectation of all parties when the case was filed. The expectation was not realized in this case because CVC used its insider position to get information from the Debtor that it needed in order to facilitate its claim purchasing. Its claim purchases gave CVC leverage in the reorganization process and enabled it to control votes which, in turn, facilitated its purchase offer. The purchase offer was memorialized in the unusual occurrence of Debtor's filing a competing plan of reorganization (the CVC plan) that proposed an entirely different reorganization (i.e., a sale to Citicorp) from the BDK plan originally filed by Debtor and which Debtor did not withdraw. The Committee's requests for information which would enable it to assist Debtor in drafting the disclosure statement were stymied while Debtor provided information to CVC and delayed providing it to the Committee. See Declaration of Samuel M. Victor In Support of Equitable Subordination of CVC's Claims (hereafter "Victor Declaration"), Adv. Docket # 116 attached to Appendix of Opening Brief of Committee, Adv. Docket # 189 at P 14. In that way, CVC caused the delay in Debtor's filing of the disclosure statement for the initial BDK plan and created significant unnecessary expense to this estate — in the millions of dollars in terms of a combination of professional fees, litigation expenses and U.S. Trustee quarterly fees due as the result of a statutory amendment to *28 U.S.C. § 1930*(a)(6) and the Third Circuit Court of Appeals' decision in *United States Trustee v. Gryphon at the Stone Mansion, Inc., 166 F.3d 552 (3d Cir. 1999).* CVC's willful conduct in its own self interest in violation of its fiduciary

duties to Debtor, the estate and its creditors is sufficient justification for further subordination of its claim to account for the increased costs and expenses it caused the estate so that its recovery is reduced beyond mere removal of its profit.

While CVC was maneuvering behind the scenes, it was tying up Debtor's resources by having Debtor modify financial projections that Debtor had prepared for the Committee and had turned over to CVC. CVC also obtained projections of working capital and income distributions and asked for a monthly model for an income statement, balance sheet and cash flow so that CVC would know the working capital changes and income statement movement within a prescribed period of time with respect to the two valuable operating subsidiaries of Debtor (Barth & Dreyfuss and Knomark). *187 B.R. at 493, 496 n. 8.* By virtue of CVC's position in having a director on Debtor's board, CVC's requests for information always received priority over the Committee's.

Postpetition, Debtor repeatedly sought extension of the exclusive period of § 1121(b). It was during this delay that CVC purchased sufficient claims to garner a blocking position for the BDK plan and obtained the information upon which to base its asset purchase offer contained in the CVC plan it caused Debtor to file. Although there was an attempt to blame the delay in filing the BDK disclosure statement on what has been called the Second Pennsylvania litigation, (essentially a landlord-tenant dispute) once the disclosure statement was filed that litigation resolved. This court stated several times during the case before the disclosure statement was filed that there was no reason for the Second Pennsylvania litigation to stall the filing of the disclosure statement. Also involved was an issue regarding American Technical Industries, Inc. ("ATI") which affected Debtor's restructuring. However, the plan was filed almost

simultaneously with the bankruptcy petition, so the ATI issue must have been considered prepetition. See *187 B.R. at 501.* The ramifications of both issues could have been explained in the disclosure statement and treated in the alternative (or as a range of distributions depending upon the outcome of the litigation) in the plan. Accordingly, there was no basis upon which to delay the filing of the disclosure statement caused by either the Second Pennsylvania or ATI issues. CVC's conduct, not the Second Pennsylvania litigation or ATI issues, caused the delay in plan confirmation.

I find that CVC caused the delay between the filing of the BDK disclosure statement and the confirmation of the BDK plan. CVC objected to confirmation of the BDK plan, even though it was one which CVC helped negotiate prepetition as a member of Debtor's board of directors. The credible evidence supports the conclusion that CVC instigated the stall in order to further pursue its self interest in having Debtor present CVC's alternative plan. This caused specific economic harm and further litigation and attendant professional fees and costs.

2. Quantifiable Economic Harm

The evidence related to the quantifiable harm includes the following. In his declaration submitted with respect to the trial, Samuel Victor of Chanin & Co., financial advisor to the Committee, stated that in his opinion the value of BDK (the reorganized debtor) stock was depressed due to CVC's disputed claim to approximately 40 percent of the reorganized Debtor. See Supplemental Remand Brief of the Committee, Adv. Docket # 199, at 13, 16; Victor Declaration at P 22.

He also stated that the delay in confirmation resulted in "foregone interest income on their debt securities distributed pursuant to the BDK Plan." Victor Declaration at P 26.[4]

The trial record reflects that as of October, 1994, administrative expenses during the delay in plan confirmation totaled $1,248,000.[5] Victor Declaration at P 26. Mr. Victor included all administrative costs incurred during the four month delay in this total because the Committee was not aware of CVC's actions in purchasing its claims. Thus, the Committee was unable to factor out any particular task for which a fee was incurred as attributable to something other than the delay. See Trial Transcript of November 14, 1995, at 71-72. Moreover, once the CVC plan was filed it became necessary for the Committee to address it. Any fees and expenses incurred in connection with the CVC plan, therefore, are attributable to CVC's undisclosed claims purchases and constitute a direct economic harm to the estate.

The trial evidence also established that creditors lost "approximately $956,250 on their debt securities distributed pursuant to the BDK plan."[6] Id. See note 4, supra. At trial

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[4] Mr. Victor calculated the interest as follows:

> "In connection with the BDK Plan, creditors received new debt securities with a face value of $33,750,000 with an annual interest rate on the debt securities of 8.5%. On a monthly basis, this translates into $239,062 of lost income incurred as a result of the delay in confirming the BDK Plan. Again, assuming a four month delay due to the actions of CVC, the cost to creditors in the aggregate is $956,250."

Victor Declaration, supra, at P 26b.

[5] The figures used herein are based on an estimate of a delay of four months. See Victor Declaration at P 26. I find the four month delay to be a conservative estimate inasmuch as the BDK plan was filed shortly after the bankruptcy case was filed in March of 1991 and the plan was not confirmed until January 21, 1992.

[6] This figure was increased in the Committee's Supplemental Remand Brief to over $1 million in lost interest and dividends and more than

Mr. Victor explained that the interest was lost because creditors could not receive their new securities and, therefore, were unable to earn interest. Trial Transcript of November 14, 1995, at 76-77.

CVC's willful conduct in its own self interest in violation of its fiduciary duties to Debtor, the estate and the creditors is a sufficient basis upon which to further subordinate its claim so that its recovery is reduced beyond the amount it paid for the claims to account for the increased costs, expenses, and lost interest it caused to the estate.

3. Uncertainty Over the Amount of CVC's Claim

This harm is not quantifiable but results from the creditors of the estate not knowing what their final distribution will be and, to the extent potential investors in the Reorganized Debtor exist, uncertainty with respect to the extent of CVC's interest in the new company. The latter has the potential to affect both existing shareholders and/or purchasers' negotiating strategies and investors' decisions with respect to the new entity. For example, even if there were a market for shares of the Reorganized Debtor, and I make no findings on this point, that market would be adversely affected because no shareholder can know the extent of his holdings until the proceedings in this adversary conclude and the amount of CVC's claim is determined once and for all.

4. The Adversary and Resulting Litigation

The third type of economic harm caused by CVC's undisclosed claims purchasing relates directly to this adversary. The Committee filed it to redress the harm caused by CVC and the fees and costs incurred for its prosecution have further minimized available funds in the reorganized entity.

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$2 million in postconfirmation attorneys fees and expenses. However, we accept the trial record as the evidence.

I cannot calculate the total dollar cost from the existing record. I will require additional submissions to permit that calculation.

During the pendency of the appeals from my 1995 order I required the filing of periodic reports with respect to the amount of compensation paid and expenses reimbursed to professionals for services rendered to the Committee. The Twenty-Fifth Report on Compensation Paid and Expenses Reimbursed, Bankruptcy case docket # 950, reflects a total of $3,242,396.73 incurred post-confirmation in professional fees and expenses on behalf of the Committee from February 15, 1992,[7] through January, 2000. From the reports, which set out only amounts paid but not an itemization of the nature of the services performed, I cannot discern whether all these fees and expenses are attributable to this Adversary. However, to the extent they are, CVC's distribution under the plan should be further subordinated by that amount. The reports do not include U.S. Trustee post-confirmation quarterly fees which have been paid, according to the docket, through the third quarter of 1999.[8] See Statement of United States Trustee in Response to 08/26/99 Order of Court, filed September 24, 1999, main docket # 948. The Committee will be given an opportunity to file a statement of fees and expenses related to this adversary, incurred through the date of this opinion. The Committee also shall be required to obtain and file a statement of U.S. Trustee post-confirmation quarterly fees paid. CVC shall have an opportunity to

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[7] The plan was confirmed on January 21, 1992.

[8] The total amount of the U.S. Trustee post-confirmation quarterly fees is not of record at this time.

respond to the Committee's submission with respect to the fees and expenses incurred from the date the adversary was filed.[9]

**Other Issues**

There are two other issues to be addressed that have been raised by CVC on this remand. CVC would like me to reevaluate the value of the BDK units (what the confirmed plan provides creditors in classes 4 and 8 in lieu of cash)[10] in light of their fair market value as now evidenced by, CVC alleges, the fact that (1) BDK, the reorganized Debtor, has not yet been sold despite confirmation of the plan eight years ago and (2) CVC would not be able to sell its BDK units if it had received them and, therefore, CVC has not received a profit. I reject this method of valuation in this instance. Valuation of BDK units was determined at the time of plan confirmation to be $1,228 per unit and no different valuation was presented at the trial of this Adversary even though one issue tried was equitable subordination. Other (nonselling) creditors have received distribution based on that valuation. It would exacerbate the harm to these creditors if BDK units were valued differently now and only for CVC's claim. The operative date of valuation for plan purposes and for purposes of this adversary was the date of plan confirmation. CVC must live with the situation it created. The District Court, in examining CVC's profit,

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[9] CVC has no basis upon which to challenge the amount of the U.S. Trustee post-confirmation quarterly fees inasmuch as those fees are statutory and their accrual is directly caused by CVC's conduct. That is, but for CVC's wrongdoing, this bankruptcy case would have been closed shortly after plan confirmation on January 21, 1992, well before Congress amended *28 U.S.C. § 1930* to require payment of post-confirmation fees.

[10] Class 8 consists of all allowed claims that are equitably subordinated. Class 4 contains all allowed prepetition unsecured claims not otherwise classified in Classes 1, 3, 5, 6, or 7 relating to First and Second Priority Notes except for equitably subordinated claims. See BDK Plan at 9-10, Bankr. No. 91-20903, Docket # 545.

also used the values established at the plan confirmation hearing. Accordingly, the original analysis showing that CVC paid $10,553,541.88 for what turned out to be $15,987,600 in value (BDK Units) under the plan is adopted for purposes of this opinion.[11]

CVC contends that my initial finding that CVC's conduct constituted improper usurpation of a corporate opportunity cannot stand unless the committee shows that the corporate opportunity would have been taken advantage of by appropriate parties. I need not consider this matter as all of my findings have been sustained on appeal and the only issue on remand is whether CVC's claim should be equitably subordinated beyond removal of its profit. However, I note

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[11] In its Reply Brief to the Committee's Supplemental Brief CVC argues that the cash value of its claim and recovery should be the appropriate measurement of any profit. CVC further asserts that because it did not receive cash and because the valuation of BDK units at plan confirmation was only for the purpose of arriving at an enterprise value of the reorganized Debtor, it is now necessary to recalculate value to determine CVC's profit. Reply Brief of Citicorp Venture Capital, Ltd. to Supplemental Brief of Committee, Docket # 201, at 3-5 and note 11 thereto. CVC has provided no authority for its argument that its claim should be valued on a basis different from that of all other creditors. To do so would be inequitable to other creditors, at least under the circumstances of this case. To achieve parity in distribution in these classes as the Bankruptcy Code requires, the court must maintain the same valuation method utilized for all distributions of BDK units to creditors in classes entitled to them. All creditors in the affected classes will sustain the same increase or diminution in the value of their holdings as CVC. Moreover, the parties had a full opportunity to litigate all issues at trial and specifically requested, prior to trial, that I withdraw my opinion on summary judgment so that the equitable subordination issues could be addressed. I did so and the case was tried in November of 1994 to address these issues. Reopening the record over 5 years after trial concluded would violate principles of finality and create a never-ending round robin of litigation.

that whether another entity would have availed itself of the opportunity is irrelevant. As the Court of Appeals pointed out in its opinion,

> under *Brown v. Presbyterian Ministers, 484 F.2d 998, 1005 (3d Cir. 1973),* the opportunity to purchase the notes was a corporate opportunity of which CVC could not avail itself, consistent with its fiduciary duty, without giving the corporation and its creditors notice and an opportunity to participate.

*160 F.3d at 987.*[12]

Based on the foregoing, we find that CVC's claim should be subordinated so that its profit is removed and the nonselling creditors are compensated for (1) lost interest, (2) the reduction in amounts available to creditors as reflected in the increased administrative and professional fees and expenses and (3) post-confirmation U.S. Trustee fees the Debtor was required to pay. To the extent CVC has an allowed Class 4 (unsubordinated) claim and receives BDK units, it will share in the distribution to that class.

An appropriate order will be entered.

Judith K. Fitzgerald

Chief Bankruptcy Judge

DATED: April 20, 2000

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[12] The court of appeals accepted "arguendo, that the purchase of notes at a discount by a fiduciary of a debtor in bankruptcy is not improper under all circumstances." *160 F.3d at 987.* However, it recognized that "there is authority arguably to the contrary, but, in light of the findings of the bankruptcy court, we . . . do not[ ] resolve the issue here. . . . It is clear . . . that a fiduciary may ordinarily purchase debt claims in fair transactions during the solvency of the corporation." Id. at note 3 (citations omitted). However, "the lower federal courts seem agreed that he cannot purchase after judicial proceedings for the relief of a debtor are expected or have begun." Id.

## INTERIM ORDER

**AND NOW**, to-wit, this **20th** day of **April, 2000,** for the reasons expressed in the foregoing Memorandum Opinion, it is **ORDERED, ADJUDGED, and DECREED** that, on or before **May 15, 2000**, the creditors' committee shall file and serve:

(1) a summary of all professional fees and expenses incurred in relation to this adversary that are not included in the $1,248,000 administrative fees incurred during the four-month plan confirmation delay;

(2) a statement of post-confirmation U.S. Trustee fees incurred and/or paid through the date of this Order.

It is **FURTHER ORDERED** that on or before **June 15, 2000,** CVC shall file and serve objections to the professional fees and expenses. If objections are filed, counsel to the committee and to CVC shall meet and confer on or before **June 27, 2000**, in an effort to agree upon the fees and expenses. If an agreement is reached, a stipulation shall be filed on or before **July 10, 2000.**

It is **FURTHER ORDERED** that if no stipulation is filed by **July 10, 2000**, a hearing on the fees and expenses to address any objections shall be held on **July 12, 2000**, at **1:30 p.m.** in Courtroom A, 54th Floor, USX Tower, 600 Grant Street, Pittsburgh, Pennsylvania. After the court resolves the fee issue, a final order will be entered determining the amount of CVC's claim that will be equitably subordinated, in accordance with the foregoing Memorandum Opinion.

It is **FURTHER ORDERED** that unless the parties reach a consensual agreement as to the total amount to be equitably subordinated, the amount the court will fix will begin with a reduction of CVC's claim sufficient to afford a distribution of its purchase price of its claims, i.e. $10,553,541.88, less $956,250 in lost interest due to the delay in plan

confirmation, less $1,248,000 in administrative costs incurred during the delay in plan confirmation, less allowed professional fees and costs attributable to this Adversary, less postconfirmation U.S. Trustee fees.

Judith K. Fitzgerald

Chief Bankruptcy Judge

**CITICORP VENTURE CAPITAL, LTD., a New York Corporation v. COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION (D.C. Civil No. 95-cv-01872); COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION v. CITICORP VENTURE CAPITAL LTD., a New York Corporation (D.C. Civil No. 95-cv-01886); COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION, Appellant in No. 97-3518; CITICORP VENTURE CAPITAL, LTD., a New York Corporation v. COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION (D.C. Civil No. 95-cv-01872); COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION v. CITICORP VENTURE CAPITAL LTD., a New York Corporation (D.C. Civil No. 95-cv-01886); CITICORP VENTURE CAPITAL, LTD. Appellant in No. 97-3519**

**NOS. 97-3518 and No. 97-3519**

**UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT**

*160 F.3d 982; 1998 U.S. App. LEXIS 29965; Bankr. L. Rep. (CCH) P77,846; 33 Bankr. Ct. Dec. 647*

**July 21, 1998, Argued**

**November 24, 1998, Filed**

**COUNSEL:**

Amy M. Tonti, Klett, Lieber, Rooney & Schorling, Pittsburgh, PA, and Paul K. Vey, Pietragallo, Bosick & Gordon, Pittsburgh, PA, and Lawrence J. Slattery (Argued), Citibank Legal Affairs Office, New York, NY, Attorneys for Citicorp Venture Capital, Ltd. Appellant in No. 97-3519.

Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, PA, and Stephen M. Ray (Argued), Stutman, Treister & Glatt, Los Angeles, CA, Attorneys for Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation, Appellant in No. 97-3518.

**JUDGES:**

BEFORE: STAPLETON and ROSENN, Circuit Judges, and RESTANI,* Judge.

**OPINION BY:**

STAPLETON

**OPINION:**

**OPINION OF THE COURT**

STAPLETON, Circuit Judge:

This appeal is from a decision in an adversary proceeding brought by plaintiff-appellant/cross-appellee Committee of Creditors Holding Unsecured Claims (the "Committee")

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* Hon. Jane A. Restani, Judge of the United States Court of International Trade, sitting by designation.

against defendant-appellee/cross-appellant Citicorp Venture Capital, Ltd. ("CVC"). The action arises out of the chapter 11 reorganization of Papercraft Corporation filed in the Western District of Pennsylvania. The Committee claims that CVC, while a fiduciary of Papercraft, secretly purchased millions of dollars of claims against Papercraft at a discount, seeking to control Papercraft's assets and make a profit at the expense of Papercraft's other creditors. CVC contends that the claims were properly purchased and that it acted in the best interests of both the company and its creditors. After a trial, the bankruptcy court entered a judgment against CVC, allowing CVC's purchased claims only to the extent of the discounted amount CVC paid for them and limiting its recovery to the percentage distribution provided in the plan multiplied by that discounted amount. On appeal, the district court agreed with the bankruptcy court's finding that CVC had breached its fiduciary duties, acted inequitably, and caused injury to Papercraft and its creditors. It disagreed, however, with the bankruptcy court's chosen remedy and remanded for a re-determination regarding the appropriate remedial action. This appeal followed.

## I. THE FACTS FOUND BY THE BANKRUPTCY COURT*

In 1985, Papercraft completed a leveraged buyout in which CVC invested $5.8 million. As a result of this transaction, CVC was given a 28% equity interest in Papercraft's direct parent, Amalgamated Investment Corp., and the right to seat one representative on the boards of directors of Amalgamated, Papercraft, and Papercraft's wholly-owned operating subsidiaries, Barth & Dreyfuss of California and Knomark, Inc. CVC's vice president, M. Saleem Muqaddam, became CVC's representative on these boards of directors, and he remained such during the time period relevant to this appeal.

Papercraft ran into financial difficulties a few years after the transaction, which forced a restructuring of the leveraged buyout ("LBO") debt. As part of the restructuring, Papercraft exchanged about 98% of its indebtedness for new First Priority Notes and Second Priority Notes. However, beginning in 1990, Papercraft was unable to meet the terms of the notes and sought to negotiate a second restructuring of its unsecured debt. An informal committee of major Papercraft creditors was formed and, after several months of negotiations, an agreement was reached on a restructuring plan. The plan, known as the "BDK plan," called for a merger of Papercraft's operating subsidiaries (Barth & Dreyfuss and Knomark) into a single entity, BDK Holdings, Inc., as part of a voluntary chapter 11 petition to be filed by Papercraft. The creditors' claims against Papercraft would then be converted into "BDK Units" consisting of stock and bonds issued by the new venture. The BDK plan was approved unanimously by Papercraft's directors, including CVC's Muqaddam, in March 1991.

Papercraft filed its voluntary petition under chapter 11 on March 22, 1991. As of the filing date, Papercraft had outstanding $90.7 million in First Priority Notes and $56.3 million in Second Priority Notes, none of which were held by CVC. Pursuant to the agreement among the creditors, Papercraft filed the BDK plan with the chapter 11 petition and an official Committee was formed to represent the interests of unsecured creditors.

Though the chapter 11 petition and BDK plan were filed in March 1991, the required Papercraft disclosure statement, a prerequisite to confirmation of the plan, was not filed until October 1991. During this delay, CVC managed to purchase over 40% of the outstanding notes, at a significant discount. CVC, despite its earlier support of the BDK plan, then objected to the confirmation of that plan and offered its

own competing plan, which called for a CVC purchase of Papercraft's assets. An account of the specific circumstances under which CVC took these actions follows.

In March 1991, Muqaddam, in a memorandum to CVC's Investment Committee, sought authorization to spend up to $10 million purchasing Papercraft notes. CVC officials granted the request in April 1991. Muqaddam, acting for CVC, then began making anonymous purchases of notes through various brokers. Between April and August 1991, CVC purchased $60,849,575.72 face value of the Papercraft notes for $10,553,541.88. These purchases represented a significant proportion of the outstanding Papercraft debt: CVC managed to acquire 38.3% of Papercraft's outstanding First Priority Notes and 46.4% of outstanding Second Priority Notes. In all, CVC's purchases amounted to 40.8% of Papercraft's total unsecured claims. It thus achieved a "blocking" position in the proposed reorganization. Although Muqaddam was a member of Papercraft's board, and therefore a fiduciary to the company and its creditors, neither he nor anyone else from CVC requested or obtained the approval of the board, the Committee, or the court before purchasing the notes. Nor did CVC disclose to any of the selling creditors its identity as buyer or its fiduciary status.

At the same time CVC was surreptitiously purchasing claims, it also requested or otherwise obtained confidential information about Papercraft's financial stability and assets, including information that was not shared with Papercraft's other creditors. In early 1991, at Muqaddam's direction, two CVC employees visited the headquarters of Papercraft's Barth & Dreyfuss subsidiary to obtain information. During that visit, CVC copied financial statements, looked at the company's product lines, held meetings with management, and toured the facilities. A written report was subsequently completed by CVC, drafts of which were shared with Papercraft personnel. Indeed, Frank Kane, Papercraft's Chief

Financial Officer, reviewed the report and gave comments directly to Muqaddam. None of this information was shared with the Committee. Papercraft personnel also forwarded a number of financial analyses and other documents directly to CVC, including a tax analysis that had been completed by a consulting firm at Muqaddam's request. In addition, a valuation of Papercraft assets and a distressed sale analysis completed by Chanin and Company, the Committee's own financial advisor, was given to CVC by Papercraft personnel.

As CVC accumulated Papercraft debt and information between April and August 1991, it also formulated a reorganization plan designed to compete with the previously filed BDK plan. Muqaddam and his staff prepared a series of reports evaluating the possibility of a CVC asset purchase offer. These reports were based, in large part, on the information about Papercraft that had been forwarded to CVC by Kane. In the course of preparing an asset purchase offer, Muqaddam held a meeting with Kane and the Bank of New York Credit Corporation ("BNYCC") to discuss financing for a CVC asset purchase offer. Muqaddam then prepared a memorandum to CVC's Investment Committee requesting authorization to purchase Papercraft's assets. This authority was granted to Muqaddam in August 1991.

In early September 1991, CVC formalized an asset purchase offer by sending a letter to Papercraft detailing the plan and announcing a financing arrangement with BNYCC. Shortly before this announcement, Muqaddam informed the Committee, for the first time, that CVC had been purchasing claims. Soon after the asset purchase offer was announced, it was filed as a plan of reorganization by Papercraft. Papercraft also filed disclosure statements for both the BDK plan and the CVC plan in October 1991.

The BDK plan disclosure statement was approved by the bankruptcy court at a hearing in December 1991. Shortly thereafter, CVC withdrew its plan of reorganization, but then

filed objections to confirmation of the BDK plan. The bankruptcy court overruled those objections and confirmed the BDK plan in January 1992.

## II. THE PRIOR PROCEEDINGS

In October 1991, the Committee initiated this adversary proceeding against CVC, objecting to the allowance of the claims CVC had purchased and seeking equitable subordination of those claims. After extensive discovery, a trial was held over two days in November 1994. After reviewing the testimony and evidence, the bankruptcy court ruled in favor of the Committee. The court held that CVC had failed to meet its fiduciary obligation to act in the best interest of Papercraft and its creditors. See *In re Papercraft Corp., 187 B.R. 486, 497 (Bankr. W.D. Pa. 1995).* It identified three adverse effects from CVC's breaches of its fiduciary duty. First, the bankruptcy court noted that the note holders who sold their claims to CVC "were deprived of the ability to make a fully informed decision concerning the sale of their claims." Id. Although they might have still decided to sell after full disclosure, "the harm lies in the fact that the selling noteholders had no opportunity to consider pertinent information." Id.

Second, the court concluded that "CVC's actions diluted the voting rights of prepetition creditors and resulted in CVC's attempt to wrest from the prepetition creditors the valuable assets of [Papercraft]." Id. Though CVC did not ultimately vote its claims, the court concluded that "nonetheless, its acquisition of claims placed it in the controlling seat in its class," *id. at 499 n. 10,* and that CVC was able to influence the negotiations surrounding the terms of the plan despite its ultimate election not to vote.

Finally, the bankruptcy court decided that CVC's actions created a conflict of interest which jeopardized its ability "to make future decisions on claims as a director free of [its]

own personal interests as [an] owner of claims. Adding to the conflict is the fact that these purchases were made at a discount from present value. This brings into play a profit motive, accentuating [its] personal interests." *Id. at 500* (quoting *In re Cumberland Farms, Inc., 181 B.R. 678, 680 (Bankr. D. Mass. 1995))*.

To remedy the adverse consequences of CVC's behavior, the bankruptcy court applied a "per se rule" that when a claim is purchased by an insider at a discount without adequate disclosure to the debtor and creditors, "the insider's newly acquired claim will be limited to the amount paid by the acquiring insider and recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim." *187 B.R. at 491*. However, the bankruptcy court declined to equitably subordinate CVC's claims.

On appeal, the district court first reviewed the findings of fact made by the bankruptcy court and found none of them clearly erroneous. Applying the facts to the test for equitable subordination, the district court agreed that CVC had acted inequitably and that this behavior had injured creditors. As for a remedy, the district court held that CVC's recovery should, at a minimum, be limited to the amount paid for its claims so as to eliminate any potential profits from the purchase of the notes. It disapproved of the bankruptcy court's per se rule, however, and remanded to the bankruptcy court for a determination of "the amount CVC's claims should be subordinated." Id.[1]

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[1] The bankruptcy court had jurisdiction over this adversary proceeding pursuant to *28 U.S.C. § § 157*(b) & 1334(b). The district court had appellate jurisdiction over the bankruptcy court's final judgment pursuant to *28 U.S.C. § 158*(a)(1). We have jurisdiction over the final decision of the district court pursuant to *28 U.S.C. § 158*(d). See *In re Indian Palms Associates, Ltd., 61 F.3d 197, 199 n. 2 (3d Cir. 1995)*.

## III. THE RIGHT TO RELIEF

Before ordering equitable subordination, most courts have required a showing involving three elements: (1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy code. *U.S. v. Noland, 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748 (1996)* (describing existing case law as consistent with the three part test identified in *In re Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977)).*[2]

### A. Inequitable Conduct

#### 1. The Legal Sufficiency of the Findings of the Bankruptcy Court

CVC acknowledges that it and its representative, Muqaddam, owed a fiduciary duty to Papercraft and its creditors at all times relevant here. It asserts, however, that neither breached a fiduciary duty. It insists that it is not improper per se for a fiduciary to purchase claims against the debtor in a bankruptcy at a discount and it stresses

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[2] This court, in *In re Burden, 917 F.2d 115, 120 (3d Cir. 1990),* concluded that "creditor misconduct is not [always] a prerequisite for equitable subordination." Burden involved subordination of a tax penalty in the absence of government misconduct. The Supreme Court, in two recent cases regarding the standards for tax penalty subordination, has refused to decide whether misconduct is required under § 510(c), resolving each case on the principle that "categorical" subordination is not permissible. See *United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 229, 135 L. Ed. 2d 506, 116 S. Ct. 2106 (1996); Noland, 517 U.S. at 543.* We need not here resolve the issue of whether misconduct is always a prerequisite to equitable subordination because the bankruptcy court properly found misconduct.

that the bankruptcy court made no finding that the prices paid for the Papercraft notes were unfair or inequitable at the time of the purchases.

We accept, arguendo, that the purchase of notes at a discount by a fiduciary of a debtor in bankruptcy is not improper under all circumstances,[3] and we acknowledge the absence of a finding on the fairness of the purchase price. The bankruptcy court found, however, that the Papercraft notes (1) were purchased for the dual purpose of making a profit for CVC on the notes and of being able to influence the reorganization in its own self-interest, (2) were purchased with the benefit of non-public information acquired as a fiduciary, and (3) were acquired without disclosure of its purchasing plans to the bankruptcy court, the Papercraft board, the Committee, or the selling note holders. The bankruptcy court further pointed out that under *Brown v. Presbyterian Ministers, 484 F.2d 998, 1005 (3d Cir. 1973),* the opportunity to purchase the notes was a corporate opportunity of which CVC could not avail itself, consistent with its fiduciary duty, without giving the corporation and its creditors notice and an opportunity to participate.

CVC primarily protests that the bankruptcy court's findings of fact concerning inequitable conduct on its part are clearly erroneous. We will address that contention in the following section. We hold here, however, that the above noted findings reflect ample inequitable conduct to support a subordination remedy. Indeed, those findings make this

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[3] There is authority arguably to the contrary, but, in light of the findings of the bankruptcy court, we need not, and do not, resolve the issue here. In *Manufacturers Trust Co. v. Becker, 338 U.S. 304, 313-14, 94 L. Ed. 107, 70 S. Ct. 127 (1949)* the court observed, ". . . If it is clear [as it is] that a fiduciary may ordinarily purchase debt claims in fair transactions during the solvency of the corporation, the lower federal courts seem agreed that he cannot purchase after judicial proceedings for the relief of a debtor are expected or have begun." (citing cases).

a paradigm case of inequitable conduct by a fiduciary as that concept has been developed in the case law, and we believe further elaboration is not required. Before turning to an analysis of the record support for these findings, we will only comment briefly on two of CVC's justifications for its conduct.

CVC insists that the opportunity to purchase the notes was not a corporate opportunity, and that notice to Papercraft's Board and the Committee was not required because Papercraft could not have purchased the notes at discount and the members of the Committee had no interest in doing so. We agree with the Committee, however, that CVC's argument is fundamentally at odds with our decision in Brown.

In Brown, we held that the availability of claims for purchase at a discount constitutes a corporate opportunity. After noting that a director of a solvent corporation may take advantage of a corporate opportunity only if he discloses the opportunity to the corporation, we further held that a director of a corporation in bankruptcy owes a fiduciary duty to creditors and cannot seize a corporate opportunity without disclosure to the creditors or their representative. Even though the director in Brown had purchased a note at discount with the consent of the corporation and its stockholders, we concluded that a breach of fiduciary duty had occurred: "The opportunity should have been disclosed to the receiver as representative of the creditors." *484 F.2d at 1005.*

CVC contends that Brown is distinguishable because Papercraft was not in a financial or legal position to purchase the notes and because the members of the Committee must have been well aware that a market existed in Papercraft debt. It necessarily follows, according to CVC, that neither could have been injured by its purchases. We believe this argument more relevant to the remedy issue than to whether a breach of fiduciary duty occurred. That duty

required that it share everything that it knew with Papercraft's board and the Committee before commencing its purchases. Its failure to do so would alone support a subordination depriving it of its profit from the note transactions. The absence of a disclosure in circumstances of this kind makes it extremely difficult to say with confidence what would have happened had no breach of duty occurred[4] and that, in itself, is a compelling reason for insisting on disclosure.

CVC also argues that its failure to disclose its identity to note sellers was not inequitable because its identity was not material to the purchases. It stresses that no note sellers have thus far complained. We agree with the bankruptcy court, however, that CVC's identity and purchasing plans were clearly material to the purchase transaction. The fact that CVC, a party with access to inside information, was seeking to purchase over $10 million in Papercraft debt and to steer the reorganization towards a sale to it of Papercraft's assets would certainly have been of interest to a creditor considering a CVC offer to purchase in the summer of 1991.

In short, we agree with the bankruptcy court, the district court, and the Committee that CVC violated its fiduciary duty in a number of significant respects.

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[4] If the attention of the Papercraft board and the Committee had been focused on the potential CVC perceived in its note purchases, it is not at all clear that Papercraft or its creditors would have been unable to tap additional resources, just as CVC did. Either or both might have been able to seize or participate in the opportunity through borrowing, court approved purchases or amendment to the plan of reorganization to include a cash-out option. See, e.g., *In re Cumberland Farms, Inc., 181 B.R. 678 (Bankr. D. Mass. 1995).*

2. Record Support for the Bankruptcy Court's Findings

CVC's most fundamental challenge to the factual findings of the bankruptcy court relates to the disclosure issue. It asserts that the court clearly erred in concluding that CVC anonymously purchased the Papercraft notes. While CVC makes no claim that it acted affirmatively to notify anyone of its purchases prior to the consummation of its purchasing plan, it maintains that the sophisticated investors on the Committee knew that CVC was buying claims and chose to keep quiet about it in order to gain a "litigation windfall" by filing suit once CVC announced its position. Specifically, CVC claims that the courts below clearly erred in finding that the Committee had no knowledge of CVC's claims purchases until after CVC announced its competing reorganization plan.

To support its argument, CVC relies upon minutes of a conference call held by the Committee on April 15, 1991. Those minutes reflect that "there was mention of the fact that American Money [a creditor of Papercraft] had sold its notes to Citicorp." App. at 1558. In addition, CVC points to testimony of the Committee's chair, Pamela Cascioli, that she had been made aware of rumors that CVC had purchased American Money's claims. However, the minutes of the conference call and the testimony of Cascioli were illuminated by witnesses at trial, who testified that the discussion during the conference call lasted thirty seconds and that such rumors are commonplace, generally unfounded, and would not normally warrant additional inquiry. The bankruptcy court credited this testimony and specifically found that, other than the rumor, the "committee heard no more about [claims purchasing activity] until CVC made its asset purchase offer in September of 1991." *187 B.R. at 492.* It appears that the bankruptcy court weighed the effect of the rumor in light of the explanatory testimony and credited

the Committee's explanation. CVC provides no convincing reason to conclude that this determination was clearly erroneous.[5]

CVC next challenges the court's finding as to its motive in purchasing the notes. It suggests that it was acting in the best interest of the company by offering a cash-out option to creditors that was not available under the BDK plan. As we have noted, however, the court found that CVC intended to profit not only from the purchase of the notes at discount but also from gaining control of the reorganization. These findings were supported, inter alia, by the testimony of CVC's own people. Muqaddam admitted that he expected to make a profit from the note purchases, and the chairman of CVC stated that those purchases would help CVC "influence something." *187 B.R. at 495-96, 500.* The evidence clearly permits an inference that CVC was primarily motivated by its own self-interest in purchasing claims. Accordingly, the court did not clearly err in drawing that inference.

CVC also contests the court's determination that its access to material, non-public information as an insider influenced its purchases of Papercraft notes. The court relied upon evidence establishing that Papercraft's then-Chief Financial Officer, Frank Kane, conducted valuations of the company based on CVC's proposed asset purchase — analyses that were not provided to the Committee. In addition, the court found that some of CVC's information was not public when received, and that CVC was given priority treatment by Papercraft in responding to requests for information. As the court accurately put it, "CVC had virtually unrestricted

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[5] CVC strenuously argues that the bankruptcy court should not be allowed to simply rest on a credibility determination when documentary evidence supports a different conclusion. However, in this case the documentary evidence was explained by the testimony at trial, which the court found credible. There is nothing unusual about a court finding credible one plausible explanation of the significance of documentary evidence.

access to inside information and significant assistance from [Papercraft] through its employees and staff and its control over employees." *Id. at 496.*

CVC argues that though it was an insider, the information it received did not differ materially from that available to the other creditors, who were all sophisticated institutional investors. The bankruptcy court's conclusion to the contrary is supported, however, by evidence that CVC obtained special financial information and financial and tax valuations in order to evaluate its own asset purchase proposal, which was itself directly supported by the note purchases. CVC's argument that the special analyses it received were immaterial rings hollow in light of its use of that information in purchasing claims and preparing its asset purchase offer.

In short, our review of the record convinces us that the crucial findings we have referenced as demonstrating inequitable conduct are not clearly erroneous.

B. Injury or Unfair Advantage

As we have noted, the bankruptcy court identified three areas of injury or unfair advantage suffered by the Committee and Papercraft as a result of CVC's secret purchase of claims at a discount. First, the court found that selling note holders were deprived of the ability to make a fully informed decision to sell their claims. Second, the court concluded that CVC diluted the voting rights of members of the Committee. Though CVC ultimately did not vote its claims, the court indicated that its purchased claims secured a position of influence over the reorganization negotiations. Finally, the court held that CVC's actions created a conflict of interest which jeopardized its ability to make decisions in the best interest of the company, free from its competing profit motive.

The district court also found these "injuries and unfair advantages" to be sufficient to warrant an equitable subordination remedy. It emphasized that CVC had "engaged in a comprehensive information collection effort made possible by its position on Papercraft's Board . . . and then used this information to prepare its own asset purchase offer which directly competed with the BDK plan." Op. at 21. While the district court makes no express reference to it, the Committee points us to trial testimony from its financial advisor indicating that this competing reorganization plan and CVC's associated objections to the BDK plan resulted in confirmation delay that inflicted substantial injury on Papercraft's non-selling creditors.

The bankruptcy court did not attempt to quantify the harms caused in economic terms, and CVC characterizes them as "noneconomic" harms. We do not agree with this characterization, however, and, like the bankruptcy and district courts, we conclude that they are sufficient to justify subordination.

C. Consistency with the Code

Finally, a remedy of equitable subordination under § 510(c) must not be inconsistent with other provisions of the bankruptcy code. This requirement "has been read as a 'reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives the result is inequitable. ' " *Noland, 517 U.S. at 539* (quoting DeNatale & Abram, The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors, *40 Bus. Law 417, 428 (1985).*

CVC makes the argument that other provisions of the bankruptcy code, including those related to voting of claims and transfer of claims, provide all the remedy necessary for inappropriate insider activity. While these provisions may also be applicable, we perceive no reason why the

availability of alternative remedies makes equitable subordination under § 510(c) incompatible with the Code under the circumstances of this case.

## IV. THE REMEDY

The bankruptcy court and the district court agreed that CVC's inequitable conduct warranted a remedy and that, at a minimum, it should not be permitted to profit by its purchase of Papercraft notes. Their agreement ended there, however. The bankruptcy court applied a per se rule that whenever an insider purchases a claim of a debtor without disclosure to the debtor and its creditors, that claim will be "allowed" under § 201 only to the extent of the amount paid and "recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim." *187 B.R. at 491.* Having imposed that remedy, the bankruptcy court concluded that equitable subordination of CVC's entire claim would "not [be] consistent with the Code." *Id. at 502.* As it explained:

> In the instant case we find that the first two[elements of equitable subordination] have been met but, because of our limitation on the allowance of CVC's claims, equitable subordination is not consistent with the Code. We have previously held that "principles of fairness would be violated if insiders who create an unfair advantage for themselves were permitted to share equally with other creditors." *In re I.D. Craig Service Corp., 1991 WL 155750* at *7 (Bankr. W.D. Pa. August 8, 1991). Because we are limiting the allowed amount of CVC's claim to the amount it paid for the claims, with recovery under the plan gauged to that amount, we have adhered to principles of fairness without the necessity of subordinating CVC's claim.

Id. at 502.

The district court held that the bankruptcy court's per se remedy did more than deprive CVC of its profit on its investment in Papercraft notes, an objective that could be accomplished by subjecting CVC claims to subordination to the extent necessary to limit its recovery to the amount paid. The district court estimated that the remedy imposed by the bankruptcy court would reduce CVC's recovery approximately $7.5 million below the amount necessary to deprive it of profit. While it acknowledged that subordination beyond that necessary to deprive CVC of profit might be warranted here, it declined to approve further subordination in the absence of appropriate findings. The court thus held:

> Because it adopted a per se rule, the Bankruptcy Court did not have the opportunity to make factual findings as to how an additional $7,489,941.88 reduction in CVC's recovery comports with the principles of equitable subordination. We do not conclude today, however, that CVC's claims may not be subordinated by such an amount but only that any amount of subordination beyond the limitation of CVC's recovery to the amount paid for such claims should be supported by factual findings and reconciled with the principles of equity. We believe this to be a finding of fact best left to the Bankruptcy Court, not this Court sitting as a court of appeal. Accordingly, we will remand the case to the Bankruptcy Court for a finding on the amount CVC's claims should be subordinated pursuant to the principles of equitable subordination.

Op. at 26-27.

We agree with the district court. At a minimum, the remedy here should deprive CVC of its profit on the purchase of the notes. That can be accomplished by subordinating CVC's claim under § 510(c) to the extent necessary in order

to limit its recovery to the purchase price of the notes.[6] Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles.[7] In the absence of such findings, neither the district court nor we are in a position to fulfill our assigned responsibility of review.

By so concluding, we do not suggest that a bankruptcy court can never impose a subordination remedy beyond disgorgement of profit without putting a specific price tag on the loss suffered by those who will benefit from the subordination. Such quantification may not always be feasible and, where that is the case, it should not redound to the benefit of the wrongdoer. A bankruptcy court should, however, attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the

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[6] We do not read the case law cited by the Committee and the bankruptcy court to suggest the contrary.

[7] In the course of reaching its holding, the district court concluded that § 510(c) is the exclusive remedy available to a bankruptcy court in circumstances like these and that the bankruptcy court was accordingly without authority to fashion a "disallowance" remedy. We do not endorse that conclusion. In *Pepper v. Litton, 308 U.S. 295, 84 L. Ed. 281, 60 S. Ct. 238 (1939)*, the Supreme Court held that the bankruptcy court exercised its statutory responsibilities as a court of equity and indicated that a purchase of claims against a debtor in bankruptcy by a fiduciary, when consistent with principles of equity, may properly lead either to the "disallowance" of the fiduciary's claim or to the subordination thereof. The rationale of Pepper would suggest that under pre-Code law a bankruptcy court was authorized to disallow a portion of the fiduciary's claim when that would produce an equitable result. We find it unnecessary here to resolve the issue as to whether equitable "disallowance" remains an available remedy. The Committee sought subordination under § 510(c), the district court has appropriately remanded this matter to the bankruptcy court for application of § 510(c), and neither side maintains that the authority granted by that section cannot be utilized to fashion a just remedy.

remedy to the injury that has been suffered by those who will benefit from the subordination. If that is not possible, the court should specifically so find.

Inherent in what we have just said is the equitable principle that any subordination should not result in a windfall to those benefitted by it based on injury to others outside the benefitted class. *Stoumbos v. Kilimnik, 988 F.2d 949, 960 (9th Cir. 1993)* ("A claim will be subordinated only to the claims of other creditors whom the inequitable conduct has disadvantaged."); *Matter of Herby's Foods, Inc., 2 F.3d 128, 131 (5th Cir. 1993)* (subordination proper only to the extent necessary to offset the harm the creditors suffered as a result of the inequitable conduct). This principle is applicable here because the Papercraft creditors who sold their claims to CVC will not benefit from any subordination. Accordingly, any injury to them must play no role in determining the extent of any subordination here of CVC's claims. If they consider themselves aggrieved, they must be left to the other remedies afforded them by law.

While we agree with CVC's criticism of the bankruptcy court's remedy, we decline to accept its argument that the record is devoid of any evidence that would support a remedy going beyond disgorgement of profit. Without limiting the inquiry of the bankruptcy court in any way, we note that there is evidence which would support a finding that the non-selling Papercraft creditors suffered injury from CVC's attempt to control the reorganization. While the bankruptcy court held, with record support, that the delay between the filing of the petition and the filing of the disclosure statement was not attributable to CVC's machinations, it made no similar finding with respect to the period of delay between the filing of the disclosure statement and confirmation of the BDK plan. Moreover, while the bankruptcy court found "no evidence that CVC engaged in conduct designed to delay the plan process," if CVC's pursuit of its own interest in fact

resulted in delay of the confirmation, we do not read that finding as inconsistent with subordination based on injury resulting from that delay. On remand, the bankruptcy court should consider whether the record supports the proposition that the non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan.

## V. CONCLUSION

The judgment of the district court will be affirmed. In accordance with that judgment, this case will be remanded to the bankruptcy court for further proceedings consistent with this opinion.

**LEXSEE 1997 U.S. Dist. LEXIS 11668**

**In re: PAPERCRAFT CORPORATION, a Pennsylvania corporation, Debtor. CITICORP VENTURE CAPITAL, LTD., a New York corporation, Appellant/Cross-Appellee, v. COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION, Appellee/Cross-Appellant.**

**Civil Action Nos. 95-1872, 95-1886**

**UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA**

***211 B.R. 813; 1997 U.S. Dist. LEXIS 11668***

**August 7, 1997, Decided**

**COUNSEL:**

For CITICORP VENTURE CAPITAL, LTD., a New York Corporation, appellant (95-CV-1872): Scott J. Davido, Jones, Day, Reavis & Pogue, Pittsburgh, PA. Paul K. Vey, Pietragallo, Bosick & Gordon, Pittsburgh, PA. Richard I. Werder, Jr., Jones, Day, Reavis & Pogue, Cleveland, OH. Shelly Crocker, Perkins Coie, Seattle, WA. Lawrence Slattery, Citcorp Legal Affairs, Trial Litigation Unit, New York, NY.

For COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AND, COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AS ESTATE REPRESENTATIVES OF PAPERCRAFT CORPORATION, appellee (95-CV-1872): George M. Cheever, Kirkpatrick & Lockhart, Pittsburgh, PA. Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, PA. Stephen M. Ray, K. John Shaffer, Stutman, Treister & Glatt, Los Angeles, CA.

For BDK HOLDINGS, movant (95-CV-1872): David Siegel, Ashok W. Mukhey, Peter J. Gregora, Irell & Manella, Los Angeles, CA.

For COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION, appellants (95-CV-1886): Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, PA. Stephen M. Ray, K. John Shaffer, Stutman, Treister & Glatt, Los Angeles, CA.

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For BDK HOLDINGS, INC., other party (95-CV-1886): David Siegel, Peter J. Gregora, Irell & Manella, Los Angeles, CA.

**JUDGES:**

CINDRICH, District Judge

**OPINION BY:**

Robert J. Cindrich

**OPINION:**

**MEMORANDUM OPINION**

CINDRICH, District Judge

August 7, 1997

This action arises from an October 12, 1995 Memorandum Opinion and Order (collectively referred as the "October 12 Order") of the United States Bankruptcy Court for the Western District of Pennsylvania (the "Bankruptcy Court"),

Bankruptcy Judge Judith K. Fitzgerald presiding. *In re Papercraft Corp., 187 B.R. 486 (Bankr. W.D. Pa. 1995).* Pending before the Court is an appeal and cross-appeal of the October 12 Order by Appellant and Cross-Appellee Citicorp Venture Capital, Ltd. ("CVC") and Appellee and Cross-Appellant Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation (the "Committee").[1] This Court has jurisdiction over this matter pursuant to *28 U.S.C. Section 158*(a)(1) and in accordance with Bankruptcy Rule 8001 as the appeal and cross-appeal arise out of a final judgment entered by the Bankruptcy Court.

I. Facts

We begin by reciting the Bankruptcy Court's findings of fact.

The following facts were established by stipulation of the parties or from the evidentiary record:

1. In 1985, Debtor, [Papercraft Corporation], completed a leveraged buyout (LBO) with the assistance of an affiliate of CVC.

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[1] The Committee is the official unsecured creditors' committee in Papercraft's chapter 11 case, whose members were duly appointed by the United States Trustee under section 1102 of title 11 of the United States Code ("Bankruptcy Code"). The Committee has sued CVC not just in its capacity as a committee entitled to bring suit by virtue of sections 502, 1103, and 1109 of the Bankruptcy Code, but as "Estate Representative" which, under the provisions of the confirmed plan of reorganization, is entitled to enforce the rights of the estate and is empowered by section 1123(b)(3)(B) of the Bankruptcy Code to do so. Opening Brief of Appellee and Cross-Appellant, Committee Of Creditors Holding Unsecured Claims And Committee Of Creditors Holding Unsecured Claims As Estate Representative Of Papercraft Corporation ("Committee's Opening Br")(Doc. No. 4) at 1 n.1.

2. The LBO transformed Debtor from a publicly traded company into a wholly-owned subsidiary of Amalgamated Investment Corporation (hereafter "Amalgamated").

3. CVC acquired a 28% equity position in Amalgamated as a result of the LBO. It wrote off the equity position in 1987 because it expected no return on its investment.

4. At all relevant times, a representative of CVC sat on the boards of directors of Amalgamated, Debtor, Barth & Dreyfuss and Knomark, subsidiaries of Debtor. After 1989, that representative was CVC's Vice President, M. Saleem Muqaddam, who served on the boards of those companies.

5. Barth & Dreyfuss and Knomark were subsidiaries of Debtor at all relevant times.

6. In April of 1989, Debtor completed a restructuring of its debt which resulted in an exchange of approximately 98% of Debtor's debentures for unsecured First Priority and Second Priority notes.

7. The First Priority Notes were issued under an Indenture dated May 15, 1989, and were to mature on October 1, 1994. An aggregate amount of $90,717,398 (principal plus accrued interest) was outstanding on the date Debtor's chapter 11 case was filed.

8. The Second Priority Notes were issued under a separate Indenture, also dated May 15, 1989, and were to mature on April 1, 1995. An aggregate amount of $56,318,767 (principal plus accrued interest) was outstanding on the date the chapter 11 case was filed.[2]

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[2] On the date of the Chapter 11 filing, the holders of First and Second Priority notes included the following: (1) Acacia Mutual Life Insurance Co. ("Acacia"); (2) American Money Management ("American Money");

9. Debtor was unable to meet the terms of the notes. Therefore, in the fall of 1990, Debtor sought another restructuring of its unsecured debt and began pre-bankruptcy negotiations with creditors who were part of what has been termed in this case the "Informal Committee".[3]

10. After several months of prepetition negotiations, Debtor and the Informal Committee reached an agreement on what is called herein the BDK Plan of Reorganization which was to be filed in conjunction with a chapter 11 case.

11. The BDK Plan would effect a reorganized enterprise and was unanimously approved by Debtor's board, including CVC through Muqaddam, in March of 1991.

12. Debtor filed a voluntary chapter 11 petition on March 22, 1991.

13. At that time, CVC held none of Debtor's First or Second Priority Notes and was not a creditor of Debtor.

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(3) Drexel Burnham Lambert ("Drexel"); (4) Executive Life Insurance Co. ("Executive"); (5) First Capital Life Insurance Co. ("First Capital"); (6) First Investors; (7) First Stratford Life Insurance Co. ("First Stratford"); (8) Magten Asset Management Corp. ("Magten"); (9) Oppenheimer & Co. ("Oppenheimer"); (10) Pan American Life Insurance Co. ("Pan American"); (11) Presidential Life Insurance Co. ("Presidential Life"); (12) the Resolution Trust Corp. ("the RTC"); (13) Transmark U.S.A. Inc. ("Transmark"); and (14) Venture Advisors ("Venture"). Appellant/Cross-Appellee's Brief In Support Of Appeal Of Order Limiting Recovery On Purchased Claims ("CVC's Opening Br") (Doc. No. 2) at 10 n.7.

[3] The members of the Informal Committee included the following: (1) Acacia; (2) American Money; (3) Columbia Savings & Loan Co.; (4) Drexel; (5) Executive; (6) Far West Savings & Loan; (7) Fidelity Bankers Life Insurance Co.; (8) Magten; (9) Oppenheimer; (10) Pan American; (11) Transmark; and (13) Venture. CVC's Opening Br at 9 n.5.

14. Debtor was insolvent on the filing date and all relevant times thereafter.

15. On March 25, 1991, three days after this bankruptcy began, Debtor filed the BDK Plan, without a disclosure statement. A disclosure statement was not filed until October 15, 1991.

16. In March of 1991, Muqaddam sought the approval of CVC's Investment Committee for CVC to purchase Papercraft notes.

17. On April 1, 1991, CVC's Investment Committee granted approval for CVC to purchase up to $10 million of Papercraft notes.

18. In early May, 1991, Muqaddam prepared a review of CVC's investment in Amalgamated.

19. CVC purchased $60,849,575.72 face value of the Papercraft notes for $10,553,541.88 between April and August of 1991. Approximately $7.4 million (more than 70%) of CVC's purchases of Papercraft notes were made on or after August 19, 1991.

20. CVC acquired 38.3% of Debtor's First Priority Notes, 46.4% of Debtor's Second Priority Notes, and 40.8% of Debtor's total unsecured claims.

21. CVC neither requested nor obtained the approval of Debtor's board, the Committee[4], or the court to buy the notes.[1a]

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[4] The members of the Committee included the following: (1) Acacia; (2) Drexel; (3) Executive; (4) First Capital; (5) Guarantee Security Life Insurance Co.; (6) J.F. Karlton Company; (7) Second Pennsylvania Real Estate Corporation; (8) Magten; (9) Pan American; (10) Presidential Life; (11) the RTC; and, (12) Transmark. CVC's Opening Br at 9 n.6.

[1a] On or about May 23, 1991, while it was a member of the Committee, Magten purchased, on behalf of clients, approximately $3.8 million in Second Priority Notes from Oppenheimer & Co. for approximately

22. Debtor learned of CVC's initial purchases of notes by May, 1991, that is, after CVC made the purchases. Its counsel became aware that CVC had purchased some claims by June of that year. Debtor and its counsel also learned of CVC's later purchases.

23. In April of 1991, the committee heard a rumor that CVC was purchasing claims. The committee heard no more about it until CVC made its asset purchase offer in September of 1991. Neither CVC nor Debtor communicated to the committee the status or extent of CVC's purchases.

24. CVC acquired the RTC's First Priority and Second Priority Notes for 25 cents and 12 cents on the dollar, respectively. Magten unsuccessfully bid for the notes at 20.5 cents and 10.5 cents. When CVC bought the RTC's notes, Muqaddam estimated that the RTC controlled approximately 20% of Debtor's total unsecured claims.

25. At the values established by this court at the BDK plan confirmation hearing, noteholders received an interest in BDK Units equal to 33.5 cents on the dollar for First Priority Note claims and 16.75 cents on the dollar for Second Priority Note claims.

26. At Muqaddam's direction, and with the knowledge and consent of Debtor's management, two employees of CVC, Noelle Cournoyer and Nils Havgestad, visited

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$379,000. Oppenheimer was a member of the Informal Committee and acknowledged in writing that it knew Magten was the purchaser. Magten also made other offers to purchase Papercraft notes, again on behalf of clients. In January, 1991, Magten entered into a settlement agreement by which it agreed to receive no more than its cost of these claims at the time of distribution under the plan. Magten disclosed to those entities from which it purchased notes its position with the committee and the bankruptcy. Unlike CVC, Magten had disclosed its identity and connection with Debtor. Furthermore, Magten was not buying notes for its own account, as was CVC, but for accounts of its customers.

Barth & Dreyfuss in January or February of 1991. The purpose of the visit was to obtain information about the company in the event that CVC decided to make an asset purchase proposal. During their 1½ day visit, CVC's representatives obtained current Barth & Dreyfuss financial statements, looked at the company's product lines, discussed the company with its management, and toured the plant.

27. Cournoyer prepared a written report on Barth & Dreyfuss, drafts of which were provided to Debtor, but not to the Committee.

28. Frank Kane, the Chief Financial Officer of Debtor, reviewed drafts of the Barth & Dreyfuss report and gave his comments to Muqaddam. Kane did not discuss the report with or provide it to the Committee.

29. Kane, Muqaddam, and a representative of the Bank of New York Credit Corporation (BNYCC), a Barth & Dreyfuss lender, held a meeting on June 14, 1991. At that meeting, Muqaddam made a presentation to BNYCC for financing a possible purchase of Barth & Dreyfuss and Knomark by CVC.

30. At some point during or after the meeting, Muqaddam gave BNYCC a copy of the Barth & Dreyfuss report and a one page summary of a possible structure for an asset purchase transaction.

31. Muqaddam received a financing term sheet from BNYCC dated August 12, 1991. He provided a copy of the term sheet to Kane and obtained Kane's comments on the term sheet. CVC agreed to the terms.

32. After the filing of the bankruptcy, Debtor, through Kane and Andre Francois, Debtor's manager of corporate accounting, reviewed documents prepared by CVC and prepared documents for Muqaddam and Cournoyer with respect to the proposed asset purchase.

33. Chanin and Company was the financial advisor to the Committee. On July 18, 1991, Debtor's Chief Executive Officer, Michael Arnold, faxed Chanin and Company's enterprise valuation to Muqaddam. Arnold received the valuation on July 16, 1991.[2a]

34. Kane faxed Chanin and Company's distressed sale analysis to Muqaddam on August 6, 1991.

35. At Muqaddam's request, Debtor engaged Arthur Andersen & Co. to analyze whether CVC's note purchases would have any adverse tax effect on Debtor.

36. Debtor received a written tax analysis from Arthur Andersen & Co. dated August 26, 1991. Kane faxed a copy of the tax analysis to Muqaddam.

37. Muqaddam prepared a memo to CVC's Investment Committee dated August 23, 1991, requesting authority to make an offer to purchase the valuable operating subsidiaries of Debtor, i.e., Barth & Dreyfuss and Knomark.

38. Thereafter, in August of 1991, CVC's Investment Committee granted Muqaddam authority to cause CVC to make an asset purchase offer.

39. On August 26, 1991, Muqaddam sought and obtained the approval of CVC's Investment Committee to increase note buying authority from $10 million to $15 million.

40. In the week before CVC made its asset purchase offer, that is, before September 13, 1991, Muqaddam called Pamela Cascioli, chairperson of the Committee,

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[2a] The parties stipulated to July 16, 1994, but the 1994 date may be a typographical error. The date that Arnold received the information is not material, however. The pertinent fact is that Muqaddam received Chanin and Company's enterprise valuation from Arnold.

and informed her that CVC was contemplating making an offer to purchase Debtor's assets. He also indicated that CVC had purchased Papercraft notes, including those held by the RTC. This was the first time that CVC informed the Committee that it intended to make an asset purchase offer. It also was CVC's first communication or confirmation to the Committee of the fact that CVC had purchased notes.[3a]

41. Shortly before September 13, 1991, Muqaddam provided drafts of an asset purchase agreement to Debtor for its review and comment.

42. CVC made its asset purchase offer in a letter to Debtor dated September 13, 1991. BNYCC had agreed to provide financing.

43. On October 15, 1991, Debtor filed an amended version of the BDK Plan which was further amended on subsequent occasions.

44. Debtor also filed a second plan, the CVC Plan, at CVC's suggestion, on October 15, 1991. CVC's asset purchase offer formed the cornerstone of the CVC Plan. CVC consented to the use of its asset purchase offer in the CVC Plan.

45. Debtor filed a disclosure statement for the Amended BDK Plan on October 15, 1991, and a disclosure statement for the CVC Plan on the same date.

46. The court approved the BDK disclosure statement on December 17, 1991.

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[3a] In his pretrial declaration, Muqaddam states that "CVC made formal disclosure to entities that were members of the Committee much earlier" than September of 1991. Defendant's Pre-Trial Evidentiary Submission, Declaration of M. Saleem Muqaddam, Docket Entry 122. However, we do not credit his statement. The weight of other testimony and all of the credible evidence establishes that this did not occur.

47. CVC filed objections to confirmation of the Amended BDK Plan on January 14, 1992, because the Committee did not agree to CVC's claim based on the face amount of the notes. The plan was confirmed on January 21, 1992.

48. Debtor retained the exclusive right to file a plan from the date of the filing of the bankruptcy through the plan confirmation.

49. When purchasing claims, CVC did so through brokers which resulted in CVC's identity not being revealed.[4a]

*In re Papercraft Corp., 187 B.R. at 491-94.*

On October 31, 1991, the Committee filed a complaint against CVC objecting to the allowance of claims CVC had purchased and seeking equitable subordination of the same. After the close of discovery, the Committee filed a motion for partial summary on its objection. By opinion and order dated April 22, 1994, the Bankruptcy Court granted the Committee's motion allowing CVC's claim as a general unsecured claim in the amount of $60,849,299.10, the face value of the notes it purchased, but limited CVC's recovery to $10,553,541.88, the amount CVC paid for its claim. *In re Papercraft Corp., 187 B.R. at 491.* The Committee's request for equitable subordination was reserved for trial. Id.

A trial was held on November 14 and 15, 1994. Both CVC and the Committee agreed that the previous summary judgment ruling should be withdrawn and requested that the Bankruptcy Court decide all issues in the case based upon

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[4a] CVC switched brokers, from Citicorp Securities Markets, Inc., to UBS Securities, when Citicorp Securities had been unsuccessful in obtaining the notes held by the RTC for CVC.

the evidence and testimony adduced at trial. Id. Accordingly, the Bankruptcy Court withdrew its April 22, 1994 opinion and order and ruled on all issues.

The Bankruptcy Court held that CVC's intention was to benefit from its position as a director of Papercraft by purchasing claims at a discount. *Id. at 497.* The Bankruptcy Court concluded that CVC had not carried out its "fiduciary obligation to act in the best interest of [Papercraft] and its estate [because it had] purchased claims without first providing Papercraft with the opportunity to make the purchases."[5] *Id. at 499.*

The Bankruptcy Court noted further that CVC's conduct had resulted in at least three adverse effects. First, the selling noteholders would have received a total distribution of $15,989,676.56 under the plan rather than the amount paid by CVC of $10,553,541.88 if they had decided not to sell after full disclosure by CVC. Although the noteholders may have still elected to sell after full disclosure, the harm lies in the fact that they "were deprived of the ability to make a fully informed decision concerning the sale of their claims." *187 B.R. at 499.*

Second, "CVC's actions diluted the voting rights of prepetition creditors and resulted in CVC's attempt to wrest from the prepetition creditors the valuable assets of [Papercraft]." *Id. 187 B.R. at 499.* The Bankruptcy Court pointed out that without full disclosure the market for claims suffers as an efficient market requires that both buyers and sellers have access to information so that all parties to the transaction can be adequately informed. Also, "because

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[5] The Bankruptcy Court explained that "appropriation of corporate opportunities by a fiduciary of an insolvent entity, even with the approval of the shareholders, directors, and officers, is impermissible when it results in a detriment to creditors." *Id. at 499* (quoting *Brown v. Presbyterian Ministers Fund, 484 F.2d 998, 1005 (3d Cir. 1973)).*

only the name of the transferee of record need be disclosed, parties in interest will be unable to ascertain who the real claims buyer is and the intentions of that claims buyer with respect to the control of a debtor." *Id. 187 B.R. at 500.*

Lastly, CVC actions created a conflict of interest which jeopardized its ability "to make future decisions of claims as a director free of [its] own personal interests as [an] owner of claims. Adding to the conflict is the fact these purchases were made at a discount from present value. This brings into play a profit motive, accentuating [its] personal interests." *Id. at 500* (quoting *In re Cumberland Farms, Inc., 181 B.R. 678, 680 (Bankr. D. Mass. 1995)).*

As a result, the Bankruptcy Court created and applied a per se rule which prohibits a debtor's insiders from purchasing claims against it without disclosing their identity and relationship with the debtor. The Court held that when claims are purchased by insiders without making such disclosures to the debtor and creditors, "the insider's newly acquired claim will be limited to the amount paid by the acquiring insider and recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim." *Id. 187 B.R. 486 at 491.* The Bankruptcy Court concluded that the "unfairness caused by CVC's conduct would not be adequately addressed absent application of a per se rule." *Id. at 501.*

The Bankruptcy Court held that further subordination of CVC's claims pursuant to the principles of equitable subordination was not appropriate. *Id. at 501.* The Court noted that equitable subordination of a creditor's claim is proper when (1) the creditor has engaged in inequitable conduct; (2) such misconduct caused injury to other creditors or the debtor or resulted in an unfair advantage to the creditor; and (3) subordination of the creditor's claim is consistent with the Bankruptcy Code. *Id. at 502* (citing *Matter of Mobile Steel Co., 563 F.2d 692, 700 (5th Cir.*

*1977))*. The Bankruptcy Court found that the first two elements had been satisfied but not the third. *Id. 187 B.R. 486 at 502.* The Court concluded that because it was limiting CVC's allowed claim to the amount it paid for such claim the principles of fairness had already been adhered to, thus, subordination of CVC's entire claim would not be consistent with the Bankruptcy Code. *Id. at 502.*

II. Standard of Review

While acting as an appellate court for a bankruptcy appeal, we may not set aside the Bankruptcy Court's factual findings unless we conclude that the determination was "clearly erroneous." Bankruptcy Rule 8013; *Fellheimer, Eichler & Braverman, P.C. v. Charter Technologies, Inc., 57 F.3d 1215, 1223 (3d Cir. 1995); First Jersey Nat'l Bank v. Brown (In re Brown), 951 F.2d 564, 567 (3d Cir. 1991).* Consequently, we accept the ultimate determination of the factfinder "unless that determination either is completely devoid of minimum evidentiary support displaying some hue of credibility or bears no rational relationship to the supportive evidentiary data." *Hoots v. Commonwealth of Pennsylvania, 703 F.2d 722, 725 (3d Cir. 1983).* In considering the evidence, "due regard shall be given the opportunity of the bankruptcy court to judge the credibility of the witnesses." Bankruptcy Rule 8013; *Fellheimer, 57 F.3d at 1223.*

Our review of the legal determinations made by the Bankruptcy Court is plenary. *Brown v. Pennsylvania St. Employees Credit Union (In re Brown), 851 F.2d 81, 84 (3d Cir. 1988).* Mixed questions of law and fact must be divided into their component parts and the appropriate standard applied to each. See *Universal Minerals, Inc. v. C.A. Hughes & Co., 669 F.2d 98, 101-103 (3d Cir. 1981).*

III. Analysis

A. Per Se Rule

The first issue we address is the Bankruptcy Court's adoption of a per se rule. Despite the laudable purpose and intent of the Bankruptcy Court in creating such a rule, for the following reasons, we conclude that it was without the authority to do so.

As previously noted, the Bankruptcy Court adopted a per se rule prohibiting insiders of a debtor from purchasing claims against it without disclosing their identity and connection with the debtor. When an insider fails to make the requisite disclosures, his or her allowed claim will be limited to the amount paid for the claim.

The Bankruptcy Court's per se rule is a new rule. As CVC correctly points out, nothing in the Bankruptcy Code proscribes insiders from purchasing claims against a debtor or requires insiders to conduct themselves in any particular way or make any particular disclosures when so doing. Thus, the rule is a formulation of "federal common law."

As the Supreme Court has repeatedly noted, there is "no general federal common law." *Texas Industries, Inc. v. Radcliff Materials, Inc., 451 U.S. 630, 640, 68 L. Ed. 2d 500, 101 S. Ct. 2061 (1981)* (quoting *Erie R. Co. v. Tompkins, 304 U.S. 64, 78, 82 L. Ed. 1188, 58 S. Ct. 817 (1938)*. "Although it is much too late to deny that there is a significant body of federal law that has been fashioned by the federal judiciary in the common-law tradition, it remains true that federal courts, unlike their state counterparts, are courts of limited jurisdiction that have not been vested with open-ended lawmaking powers." *Northwest Airlines, Inc. v. Transport Workers Union of America, AFL-CIO, 451 U.S. 77, 95, 67 L. Ed. 2d 750, 101 S. Ct. 1571 (1981).*

Nevertheless, the Court has recognized the need and authority in some limited areas to formulate what has been known as "federal common law." These instances are "few and restricted," and fall into essentially two categories: those in which a federal rule of decision is "necessary to protect uniquely federal interests," and those in which Congress has given the courts power to develop substantive law.

*Texas Industries, 451 U.S. at 640* (citations and quotations omitted). The instant case falls into neither of these categories, however. There are no uniquely federal interests at issue[6] nor does the Bankruptcy Code contain a provision giving the federal courts broad power to develop federal common law.[7] See *28 U.S.C. Section 2075* ("Bankruptcy rules: The Supreme Court shall have the power to prescribe by general rules, the forms of process, writs, pleadings, and

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[6] Cases in which a federal rule of decision is necessary to protect uniquely federal interest are "those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of States or our relations with foreign nations, and admiralty cases." *Texas Industries, 451 U.S. at 641.*

[7] The Supreme Court has held that Congress empowered the courts to develop substantive law in the area of labor law, *Textile Workers Union of Am. v. Lincoln Mills of Ala., 353 U.S. 448, 1 L. Ed. 2d 972, 77 S. Ct. 912 (1957)* (holding that Section 301(a) of the Labor Management and Relations Act, *29 U.S.C. Section 185*(a) not only grants jurisdiction over defined areas of labor law but also vests in the courts the power to develop a common law of labor-management relations within that jurisdiction), and antitrust law, *Texas Industries, 451 U.S. at 642-43* (holding that Congress intended to allow federal courts to develop common law with regard to substantive violations of the Sherman Act but not with regard to the formulation of remedies for enforcement). There is nothing in the Bankruptcy Code, however, which intimates that Congress intended to delegate to the federal courts any general power to create federal common law. See John T. Cross, Congressional Power To Extend Federal Jurisdiction To Disputes Outside Article III: A Critical Analysis From The Perspective Of Bankruptcy, *87 NW. U.L. Rev. 1188, 1227 (1993).*

motions, and the practice and procedure in cases under Title 11. Such rules shall not abridge, enlarge, or modify any substantive right.").

We recognize that "in almost any statutory scheme, there may be a need for judicial interpretation of ambiguous or incomplete provisions. But the authority to construe a statute is fundamentally different from the authority to fashion a new rule or to provide a new remedy which Congress has decided not to adopt." *Northwest Airlines, 451 U.S. at 97.* Indeed, the presumption that Congress deliberately omitted the enactment of a rule is strongest when it has enacted comprehensive legislation in an area such as Bankruptcy. See Id.[8] As previously noted, there is no requirement in the Bankruptcy Code or Rules equivalent to the Bankruptcy Court's new per se rule. Thus, the Bankruptcy Court's ruling goes beyond judicial interpretation of ambiguous or incomplete provisions of an existing statute. While we agree that there are strong public policy arguments in favor of the Bankruptcy Court's per se rule, Congress and not the court must enact such a rule.

We find it significant that a rule already exists to address inequitable conduct by insiders trading in a debtor's claims, Section 510 of the Bankruptcy Code.[9] Section 510 is a

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[8] See also *Resolution Trust Corp. v. Liebert, 871 F. Supp. 370, 372 (C.D. Cal. 1994)* (A Financial Institution Reform, Recovery, and Enforcement Act case. "Once Congress enacts comprehensive legislation in a particular area, the courts may not add extra federal rules not derived from the legislation itself."); *Port Allen Marine Services, Inc. v. Chotin, 765 F. Supp. 887, 890 (M.D. La. 1991)* (A Comprehensive Environmental Response, Compensation and Liability Act case. "The Court's function is to interpret the law and not to amend or supplement a law enacted by the Congress. For this court 'to supply omissions transcends the judicial function.'" (quoting *West Virginia Univ. Hosp. v. Casey, 499 U.S. 83, 101, 113 L. Ed. 2d 68, 111 S. Ct. 1138 (1991)).*

[9] Insider trading in a debtor's claims is not a new phenomenon. As exhibited by the case law, litigation arising from insider trading has

codification of the common law doctrine of equitable subordination and is grounded in the court's equitable powers.[10] As we discuss in the next section, the Bankruptcy Court may utilize its equitable powers pursuant to Section 510 and subordinate an insider's claim for harm caused by his or her egregious conduct. Thus, Section 510 requires the Bankruptcy Court to determine on a case-by-case basis whether a claim should be subordinated. The per se rule, on the other hand, removes the principles of equity and applies instead a universal penalty for any instance of noncompliance. We are not unmindful of the additional burden placed on the Bankruptcy Court in applying the rules of equitable subordination to cases of this kind. See p.17 et seq., infra. Nonetheless, because we can find no support in the law for the adoption of a per se rule, we are compelled to reverse.

B. Equitable Subordination

The Committee argues that equitable subordination is an alternative ground to affirm the Bankruptcy Court's decision to limit CVC's claims to the amount it paid for them.

The test for equitable subordination can be found in the often cited case of *Matter of Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977).* The following three conditions must be satisfied before a claim may be subject to equitable subordination: (1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable

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plagued the courts for at least the last 144 years. See *Hill v. Frazier, 22 Pa. 320 (1853).*

[10] We note that the parties have cited to no common law doctrine, nor has our research revealed any, which resembles the Bankruptcy Court's per se rule.

subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act. *Id. at 699-700* (citations omitted).

"In determining whether these three conditions are satisfied three principles must be kept in mind." *Id. at 700.* First, "inequitable conduct directed against the bankrupt or its creditors may be sufficient to warrant subordination of a claim irrespective of whether it was related to the acquisition or assertion of that claim." Id. Second, "a claim or claims should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct." *Id. at 701.* Finally, a party seeking equitable subordination of a creditor's claim usually has the burden of proof. A proof of claim executed and filed in accordance with the Bankruptcy Code constitutes a prima facie valid claim. *Id. at 702 n.11.* A party objecting to such a claim "must come forward with enough substantiations to overcome the claimant's prima facie case and thus compel him to actually prove the validity and honesty of his claim." *Id. at 701* (quotation omitted).

Although there is an initial presumption of validity that attaches to all claims, claims asserted by fiduciaries demand closer scrutiny. *Id. 563 F.2d at 701-02* ("We must examine the conduct of fiduciary-claimants 'with a large measure of watchful care.'" (citations omitted; quoting *Richardson's Extr. v. Green, 133 U.S. 30, 43, 10 S. Ct. 280, 33 L. Ed. 516 (1890)).* Indeed, insider transactions are subjected to rigorous scrutiny and when challenged, the burden is on the insider not only to prove the good faith of a transaction but also to show the inherent fairness from the viewpoint of the corporation and those with interests therein. *Pepper v. Litton, 308 U.S. 295, 306, 84 L. Ed. 281, 60 S. Ct. 238 (1939).*

The Bankruptcy Court held that the first two conditions, (1) inequitable conduct and (2) injury or unfair advantage, had been satisfied but not the third, (3) consistency with

the Bankruptcy Code. *In re Papercraft, 187 B.R. at 502.* The Court concluded that because CVC's claims were already being limited to the amount it paid for such claims, the principles of fairness had already been adhered to.[11] Id. Thus, the Court held, subordination of CVC's entire claim would not be consistent with the Bankruptcy Code. Id.

As set forth in the following discussion, we find that CVC's claims should be limited to pursuant to the principles of equitable subordination. We do not agree with the Committee, however, that equitable subordination is an alternative grounds to affirm the October 12 Order. As we explain below, a court must make certain findings regarding the amount of subordination, findings which were not made by the Bankruptcy Court in the instant case. We now review the Bankruptcy Court's findings in connection with equitable subordination.

1) *Inequitable Conduct*

The Bankruptcy Court held that CVC engaged in inequitable conduct. *In re Papercraft, 187 B.R. 486 at 502.* The Court concluded that CVC "did not carry out [its] fiduciary obligation to act in the best interests of [Papercraft] and its estate." *Id. at 499.* Specifically, the Court found that CVC did not engage in an arm's length transaction when it purchased Papercraft's claims. *Id. at 499.* The Court also found that CVC had appropriated a corporate opportunity

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[11] The Court stated that the limitation of CVC's allowed claim to the amount CVC paid for such claim adheres to the principles of fairness because,

> the limitation of recovery removes CVC's profit, discourages similar future conduct and provides a recovery on the claims of creditors in CVC's class which is greater than they would have had absent this limitation. It also removes any economic advantage CVC gained over other insiders who honored their duties and did not purchase claims without the appropriate disclosures.

*Id. 187 B.R. 486 at 502.*

when it, as a fiduciary, purchased Papercraft's claims at a discount and then sought to enforce such claims at full value. Id. Based upon the evidence as a whole, the Court held that "CVC's intention was to benefit from its position as a director of [Papercraft] by purchasing claims at a discount." *Id. at 497.*

We find that there is sufficient evidence to support the Bankruptcy Court's finding that CVC engaged in inequitable conduct. CVC does not dispute that it was an insider as defined by *11 U.S.C. 101*(31)(B) because of its representation on Papercraft's Board of Directors. *Id. 187 B.R. 486 at 494-95.* As an insider, CVC owed a fiduciary duty to Papercraft, and upon Papercraft's becoming insolvent, such duty extended to Papercraft's creditors. See *Pepper, 308 U.S. 295 at 307, 84 L. Ed. 281, 60 S. Ct. 238; Brown, 484 F.2d at 1005.*

A fiduciary who purchases claims of an insolvent debtor at a discount without providing the debtor an opportunity to make the purchases for the benefit of all the creditors has violated his or her fiduciary duty to act in the best interest of the insolvent debtor and creditors. See, e.g., *In re Cumberland Farms, Inc., 181 B.R. 678 (Bankr. D. Mass. 1995).* Such conduct by a fiduciary clearly supports a finding of inequitable conduct. See, e.g., *Bostian v. Schapiro (In re Kansas City Journal-Post Co.), 144 F.2d 791 (8th Cir. 1944);* In *re UVAS Farming Corp., 91 B.R. 575 (Bankr. D. N.M. 1988).*

2) *Injury or Unfair Advantage*

The Bankruptcy Court held that the second element of equitable subordination had been satisfied. As previously noted, the Bankruptcy Court held that CVC's conduct had resulted in at least three adverse effects. The Court's findings also support a finding that CVC created an unfair advantage for itself.

As described more fully in the October 12 Order, CVC engaged in a comprehensive information collection effort made possible by its position on Papercraft's Board. *In re Papercraft, 187 B.R. 486 at 494-96.* CVC then used this information to prepare its own asset purchase offer which directly competed with the BDK plan. That CVC utilized Papercraft's personnel and resources and the Committee's financial advisor, all without the Committee's knowledge, makes its actions even more culpable. Accordingly, we find that the Bankruptcy Court's finding of this element was supported by the evidence and not clearly erroneous.

3) *Consistency With The Bankruptcy Code*

The Bankruptcy Court concluded that because CVC's allowed claims had already been limited to the amount it paid for such claims pursuant to its per se rule, equitable subordination would not be consistent with the Bankruptcy Code. *Id. 187 B.R. 486 at 502.* The Court stated that "because we are limiting the allowed amount of CVC's claim to the amount it paid for the claims, with recovery under the plan gauged to that amount, we have adhered to the principles of fairness without the necessity of subordinating CVC's claim." Id.

The Bankruptcy Court's conclusion was with regard to whether CVC's remaining claim, that is the amount remaining after application of the per se rule, should be subordinated. Apparently, the Court found that further subordination would not be consistent with the Bankruptcy Code because as it correctly noted, equitable subordination is appropriate only to the extent necessary to offset any harm to the debtor or other creditors. *Id. 187 B.R. 486 at 501-02.*

Although the Bankruptcy Court identified several harmful effects resulting from CVC's conduct, the Court did not address the amount of harm in economic terms. The Bankruptcy Court concluded instead that "the usual remedy for

the improper purchase of claims at a discount by a fiduciary is to subordinate or disallow the fiduciary's claim to the extent its face amount exceeds the amount paid." *In re Papercraft, 187 B.R. 486 at 501* (citing *In re Norcor Mfg. Co., 109 F.2d 407 (7th Cir. 1940); In re Philadelphia & W. Ry. Co., 64 F. Supp. 738 (E.D. Pa. 1946)).* The Bankruptcy Court stated this conclusion in support of the amount of subordination of CVC's claims pursuant to the per se rule. *In re Papercraft, 187 B.R. at 501.* While we agree with the Bankruptcy Court's conclusion that a fiduciary who purchases claims against an insolvent debtor shall ordinarily have his or her claim subordinated, we do not agree that the amount of such subordination is usually equal to the limitation imposed by its per se rule.[12]

In addition to the cases cited by the Bankruptcy Court, the Committee cites several other cases which allegedly support the proposition that the remedy in such circumstances is that the fiduciary's allowed claim will be limited to his or her purchase price with recovery under the bankruptcy plan being gauged to such reduced claim.[13] The courts in these

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[12] The economic impact of the Bankruptcy Court's ruling on CVC is severe. As previously noted, CVC purchased a total of $60,849,575.72 in face value of Papercraft's First and Second Priority notes for $10,553,541.88, an average of approximately $0.24 on the dollar for First Priority notes and $0.12 on the dollar for Second Priority notes. CVC's Opening Br at 11-13. At the values established by the Bankruptcy Court at the plan confirmation hearing, noteholders are to receive BDK Units equal to $0.335 on the dollar for First Priority note claims and $0.1675 on the dollar for Second Priority note claims. *In re Papercraft, 187 B.R. 486 at 492.* Under the Bankruptcy Court's holding, which limits CVC's allowed claim to the $10,553,541.88 purchase price with recovery under the plan gauged to this amount, CVC would recover only about $3,063,600 in BDK Units on its claims, approximately $7,489,941.88 less than what it paid. If CVC's claims were allowed at face value, however, it would recover approximately $15,987,600 in BDK Units, $5,434,058.12 more than what it paid for the claims. See CVC's Opening Br at 17.

[13] The Committee's Opening Br at 35 (citing *Allied Eastern States Maintenance Corp. v. Miller (In re Lemco Gypsum, Inc.), 911 F.2d 1553,*

cases do hold that a fiduciary's claim purchased when the debtor was insolvent will be limited to the amount paid. A more thorough reading of these cases reveals, however, that what is being subordinated is the fiduciary's profits. None of these cases holds that a fiduciary's allowed claim will be limited to the amount paid *with recovery under the plan being gauged to such allowed claim*. To the contrary, these cases apparently hold that a fiduciary's *recovery* on claims purchased when the debtor is insolvent will be limited to the amount paid for such claims.[14]

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*1558 (11th Cir. 1990); In re Cumberland Farms, Inc., 181 B.R. 678 at 681; Matter of Executive Office Centers, Inc., 96 B.R. 642, 649-50 (Bankr. E.D. La. 1988);* Minkel & Baker, Claims & Control In Chapter 11 Cases: A Call For Neutrality, *13 Cardozo L. Rev. 35, 61 n.111 (1991)* (citing *Sampsell v. Bridgford (In re Bridgford Co.), 237 F.2d 182 (9th Cir. 1956); Monroe v. Scofield (In re Gallic-Vulcan Mining Corp.), 135 F.2d 725 (10th Cir. 1943); Terminal & Shaker Heights Realty Co. v. Van Sweringen Co. (In re Van Sweringen Co.), 119 F.2d 231 (6th Cir. 1941); In re Norcor, 109 F.2d at 407 (7th Cir. 1940); In re Philadelphia & W. Ry. Co., 64 F. Supp. 738 (E.D. Pa. 1946); In re Jersey Materials Co., 50 F. Supp. 428 (D. N.J. 1943); In re Los Angeles Lumber Prods. Co., 46 F. Supp. 77 (S.D. Cal. 1941); In re McCrory Stores Corp., 12 F. Supp. 267 (S.D. N.Y. 1935)).*

[14] See *Sampsell, 237 F.2d at 186* (Fiduciary "is precluded from collecting more than he paid for a claim against an insolvent corporation to which he owed a fiduciary duty."); *Monroe, 135 F.2d at 728* (Fiduciary "is limited in his right of recovery to the $200 which he paid for his claim."); *In re Van Sweringen, 119 F.2d at 235* ("Where the directors of a corporation, contrary to their fiduciary duty, have made a personal profit in their dealings with the corporation, equity will compel them to account to the corporation for such profits made at its expense."); *In re Norcor, 109 F.2d at 411* (Fiduciaries are not "entitled to the allowance of a claim in an amount which would have inured to his individual profit."); *In re Philadelphia & W. Ry., 64 F. Supp. at 740-41* ("These directors will not be compelled to account for profits from sales of bonds which had been purchased in good faith before their appointment but only for such profit as they realized from the sales of bonds purchased during their incumbency."); *In re Jersey Materials, 50 F. Supp. at 431* (Fiduciary "should recover for the bankrupt estate no more than the sum of money paid by him for the mortgage, together with interest from the date he

When stating that a fiduciary's claim would be allowed up to the amount paid, these courts did not hold that the fiduciary's recovery would then be gauged to such allowed claim, but instead allowed the claim only to an amount which would disgorge any profits to be made. In contrast, the term "allowed claim" as used in the instant case takes on a more precise meaning as the Bankruptcy Court went one step further by adding to its holding that CVC's recovery under the plan would be gauged to the already reduced claim.

Indeed, these cases rely on the universal precept that a fiduciary may not "serve himself first and his cestuis second." *Pepper, 60 S. Ct. at 247.* As Justice Cardozo noted in the often quoted passage from *Meinhard v. Salmon, 249 N.Y. 458,* 164 N.E.545, 546 (1928):

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held by something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. . . . Only thus has

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paid it."); *In re McCrory Stores, 12 F. Supp. at 268-69* (Corporation in bankruptcy in which creditors were to receive full payment of their claims under proposed bankruptcy plan. "A director who acquires claims [when the debtor is insolvent] may enforce them for no more than the cost of acquisition. [Director] then was inhibited from making a profit. . . ."); *Matter of Executive Office Centers, 96 B.R. 642 at 650* (Denying creditor's motion to subordinate claim because neither it nor any other creditor was harmed citing to In re Van Sweringen, In re Norcor, and In re Philadelphia & W. Ry., as standing for the proposition that the basis for limiting a fiduciary's claim is "that a fiduciary shall not be allowed to profit from his trust.").

> the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

The courts have made it clear that a fiduciary is not entitled to any profits resulting from the purchase of claims against an insolvent debtor. Thus, CVC's claims should at a minimum be limited to the amount paid for such claims to eliminate any potential profits. If we affirm the October 12 Order, however, CVC's projected recovery will be reduced by an additional $7,489,941.88. As explained by the Ninth Circuit in *In re Westgate-California Corp., 642 F.2d 1174, 1177-78 (9th Cir. 1981):*

> Subordination is an equitable power and is therefore governed by equitable principles.
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> * * *
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> The time-honored maxim that equity will not enforce a penalty adds another limitation to the subordination power. Bankruptcy courts must take care not to subordinate claims where doing so will operate only to penalize the claimant. "The power of subordination necessarily must be measuredly and not blankly exercised. . . . It should not operate to take away anything punitively to which one creditor is justly entitled in view of the liquidation finality, and bestow it upon others, who in the relative situation have no fair right to it. It can therefore ordinarily go no farther than to level off actual inequitable disparities on the bankruptcy terrain for which a creditor is responsible, to the point where they will not create unjust disadvantages in claim positions and liquidation results."

(quoting *Bostian, 144 F.2d at 800-01);* see also, *Matter of Mobile Steel Co., 563 F.2d at 701* ("If a claimant guilty of misconduct asserts two claims, each worth $10,000, and

the injury he inflicted on the bankrupt or its creditors amounted to $10,000, only one of his claims should be subordinated."); *Matter of Pinetree Partners, Ltd., 87 B.R. 481, 488 (Bankr. N.D. Ohio 1988)* (claims should be subordinated only to extent necessary to offset the harm the bankrupt and its creditors suffered).

As we previously noted, because it adopted a per se rule, the Bankruptcy Court did not have the opportunity to make factual findings as to how an additional $7,489,941.88 reduction in CVC's recovery comports with the principles of equitable subordination. We do not conclude today, however, that CVC's claims may not be subordinated by such an amount but only that any amount of subordination beyond the limitation of CVC's recovery to the amount paid for such claims should be supported by factual findings and reconciled with the principles of equity. We believe this to be a finding of fact best left to the Bankruptcy Court, not this Court sitting as a court of appeal. Accordingly, we will remand the case to the Bankruptcy Court for a finding on the amount CVC's claims should be subordinated pursuant to the principles of equitable subordination.

**LEXSEE 1995 Bankr. LEXIS 1478**

**In Re: PAPERCRAFT CORPORATION, a Pennsylvania corporation, Debtor(s); COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION, Plaintiff vs. CITICORP VENTURE CAPITAL, LTD., a New York corporation, Defendant**

**Bankruptcy No. 91-00903 JKF, Chapter 11, Adversary No. 91-0642**

**UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA**

***187 B.R. 486; 1995 Bankr. LEXIS 1478; Bankr. L. Rep. (CCH) P76,826; 34 Collier Bankr. Cas. 2d (MB) 745; 27 Bankr. Ct. Dec. 1252***

**October 12, 1995, Decided**

**COUNSEL:**

For Plaintiff: Philip E. Beard, Esquire, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, Pennsylvania. Stephan M. Ray, Esquire, Stutman, Treister & Glatt, Los Angeles, California.

For Defendant: Paul K. Vey, Esquire, Pietragallo, Bosick & Gordon, Pittsburgh, Pennsylvania.

**JUDGES:**

Judith K. Fitzgerald, United States Bankruptcy Judge

**OPINION BY:**

Judith K. Fitzgerald

**OPINION:**

**MEMORANDUM OPINION**

The matter before the court is an action by the Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation (hereafter collectively "creditors' committee" or "committee") for equitable subordination and objecting to the claim of Citicorp Venture Capital, Ltd. (hereafter "CVC"). Previously this court addressed the allowance of the claim on a motion for partial summary judgment. By opinion and order dated April 22, 1994, we granted partial summary judgment to the committee. We allowed CVC's claim as a general unsecured claim in the amount of $60,849,299.10, the face value of the notes it purchased, but limited CVC's recovery to $10,553,541.88, the amount CVC paid for its claim. On November 14 and 15, 1994, trial was held to determine whether CVC's claim should be equitably subordinated. At the conclusion of trial the parties requested that we decide all issues raised in the adversary complaint based on the evidence and testimony adduced at trial.

In accordance with that request, we have considered the evidence, testimony, arguments, pleadings and briefs and vacate our order of April 22, 1994, granting partial summary judgment. Accordingly, we withdraw the opinion that accompanied the April 22, 1994, order. We now conclude that it is appropriate to apply a per se rule prohibiting insiders of a debtor from purchasing claims against it without disclosing their identity and connection with the debtor. We further hold that, when claims are purchased by insiders without the requisite disclosure to the debtor and creditors, the allowed amount of the insider's newly acquired claim will be limited to the amount paid by the acquiring insider

and recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim.

The following facts were established by stipulation of the parties or from the evidentiary record:

1. In 1985, Debtor completed a leveraged buyout (LBO) with the assistance of an affiliate of CVC.

2. The LBO transformed Debtor from a publicly traded company into a wholly-owned subsidiary of Amalgamated Investment Corporation (hereafter "Amalgamated").

3. CVC acquired a 28% equity position in Amalgamated as a result of the LBO. It wrote off the equity position in 1987 because it expected no return on its investment.

4. At all relevant times, a representative of CVC sat on the boards of directors of Amalgamated, Debtor, Barth & Dreyfuss and Knomark, subsidiaries of Debtor. After 1989, that representative was CVC's Vice president, M. Saleem Muqaddam, who served on the boards of those companies.

5. Barth & Dreyfuss and Knomark were subsidiaries of Debtor at all relevant times.

6. In April of 1989, Debtor completed a restructuring of its debt which resulted in an exchange of approximately 98% of Debtor's debentures for unsecured First Priority and Second Priority notes.

7. The First Priority Notes were issued under an Indenture dated May 15, 1989, and were to mature on October 1, 1994. An aggregate amount of $90,717,398 (principal plus accrued interest) was outstanding on the date Debtor's chapter 11 case was filed.

8. The Second priority Notes were issued under a separate Indenture, also dated May 15, 1989, and were to mature on April 1, 1995. An aggregate amount of $56,318,767 (principal plus accrued interest) was outstanding on the date the chapter 11 case was filed.

9. Debtor was unable to meet the terms of the notes. Therefore, in the fall of 1990, Debtor sought another restructuring of its unsecured debt and began pre-bankruptcy negotiations with creditors who were part of what has been termed in this case the "Informal Committee".

10. After several months of prepetition negotiations, Debtor and the Informal Committee reached an agreement on what is called herein the BDK Plan of Reorganization which was to be filed in conjunction with a chapter 11 case.

11. The BDK Plan would effect a reorganized enterprise and was unanimously approved by Debtor's board, including CVC through Muqaddam, in March of 1991.

12. Debtor filed a voluntary chapter 11 petition on March 22, 1991.

13. At that time, CVC held none of Debtor's First or Second Priority Notes and was not a creditor of Debtor.

14. Debtor was insolvent on the filing date and all relevant times thereafter.

15. On March 25, 1991, three days after this bankruptcy began, Debtor filed the BDK Plan, without a disclosure statement. A disclosure statement was not filed until October 15, 1991.

16. In March of 1991, Muqaddam sought the approval of CVC's Investment Committee for CVC to purchase Papercraft notes.

17. On April 1, 1991, CVC's Investment Committee granted approval for CVC to purchase up to $10 million of Papercraft notes.

18. In early May, 1991, Muqaddam prepared a review of CVC's investment in Amalgamated.

19. CVC purchased $60,849,575.72 face value of the Papercraft notes for $10,553,541.88 between April and August of 1991. Approximately $7.4 million (more than 70%) of CVC's purchases of Papercraft notes were made on or after Aug 19, 1991.

20. CVC acquired 38.3% of Debtor's First Priority Notes, 46.4% of Debtor's Second Priority Notes, and 40.8% of Debtor's total unsecured claims.

21. CVC neither requested nor obtained the approval of Debtor's board, the creditors' committee, or the court to buy the notes.[1]

22. Debtor learned of CVC's initial purchases of notes by May, 1991, that is, after CVC made the purchases. Its counsel became aware that CVC had purchased some claims by June of that year. Debtor and its counsel also learned of CVC's later purchases.

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[1] On or about May 23, 1991, while it was a member of the creditors' committee, Magten purchased, on behalf of clients, approximately $3.8 million in Second Priority Notes from Oppenheimer & Co. for approximately $379,000. Oppenheimer was a member of the Informal Committee and acknowledged in writing that it knew Magten was the purchaser. Magten also made other offers to purchase Papercraft notes, again on behalf of clients. In January, 1991, Magten entered into a settlement agreement by which it agreed to receive no more than its cost of these claims at the time of distribution under the plan. Magten disclosed to those entities from which it purchased notes its position with the committee and the bankruptcy. Unlike CVC, Magten had disclosed its identity and connection with Debtor. Furthermore, Magten was not buying notes for its own account, as was CVC, but for accounts of its customers.

23. In April of 1991, the committee heard a rumor that CVC was purchasing claims. The committee heard no more about it until CVC made its asset purchase offer in September of 1991. Neither CVC nor Debtor communicated to the committee the status or extent of CVC's purchases.

24. CVC acquired the RTC's First Priority and Second Priority Notes for 25 cents and 12 cents on the dollar, respectively. Magten unsuccessfully bid for the notes at 20.5 cents and 10.5 cents. When CVC bought the RTC's notes, Muqaddam estimated that the RTC controlled approximately 20% of Debtor's total unsecured claims.

25. At the values established by this court at the BDK plan confirmation hearing, noteholders received an interest in BDK Units equal to 33.5 cents on the dollar for First Priority Note claims and 16.75 cents on the dollar for Second Priority Note claims.

26. At Muqaddam's direction, and with the knowledge and consent of Debtor's management, two employees of CVC, Noelle Cournoyer and Nils Havgestad, visited Barth & Dreyfuss in January or February of 1991. The purpose of the visit was to obtain information about the company in the event that CVC decided to make an asset purchase proposal. During their 1 day visit, CVC's representatives obtained current Barth & Dreyfuss financial statements, looked at the company's product lines, discussed the company with its management, and toured the plant.

27. Cournoyer prepared a written report on Barth & Dreyfuss, drafts of which were provided to Debtor, but not to the committee.

28. Frank Kane, the Chief Financial Officer of Debtor, reviewed drafts of the Barth & Dreyfuss report and gave his comments to Muqaddam. Kane did not discuss the report with or provide it to the committee.

29. Kane, Muqaddam, and a representative of the Bank of New York Credit Corporation (BNYCC), a Barth & Dreyfuss lender, held a meeting on June 14, 1991. At that meeting, Muqaddam made a presentation to BNYCC for financing a possible purchase of Barth & Dreyfuss and Knomark by CVC.

30. At some point during or after the meeting, Muqaddam gave BNYCC a copy of the Barth & Dreyfuss report and a one page summary of a possible structure for an asset purchase transaction.

31. Muqaddam received a financing term sheet from BNYCC dated August 12, 1991. He provided a copy of the term sheet to Kane and obtained Kane's comments on the term sheet. CVC agreed to the terms.

32. After the filing of the bankruptcy, Debtor, through Kane and Andre Francois, Debtor's manager of corporate accounting, reviewed documents prepared by CVC and prepared documents for Muqaddam and Cournoyer with respect to the proposed asset purchase.

33. Chanin and Company was the financial advisor to the committee. On July 18, 1991, Debtor's Chief Executive Officer, Michael Arnold, faxed Chanin and Company's enterprise valuation to Muqaddam. Arnold received the valuation on July 16, 1991.[2]

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[2] The parties stipulated to July 16, 1994, but the 1994 date may be a typographical error. The date that Arnold received the information is not material, however. The pertinent fact is that Muqaddam received Chanin and Company's enterprise valuation from Arnold.

34. Kane faxed Chanin and Company's distressed sale analysis to Muqaddam on August 6, 1991.

35. At Muqaddam's request, Debtor engaged Arthur Andersen & Co. to analyze whether CVC's note purchases would have any adverse tax effect on Debtor.

36. Debtor received a written tax analysis from Arthur Andersen & Co. dated August 26, 1991. Kane faxed a copy of the tax analysis to Muqaddam.

37. Muqaddam prepared a memo to CVC's Investment Committee dated August 23, 1991, requesting authority to make an offer to purchase the valuable operating subsidiaries of Debtor, i.e., Barth & Dreyfuss and Knomark.

38. Thereafter, in August of 1991, CVC's Investment Committee granted Muqaddam authority to cause CVC to make an asset purchase offer.

39. On August 26, 1991, Muqaddam sought and obtained the approval of CVC's Investment Committee to increase note buying authority from $10 million to $15 million.

40. In the week before CVC made its asset purchase offer, that is, before September 13, 1991, Muqaddam called Pamela Cascioli, chairperson of the creditors' committee, and informed her that CVC was contemplating making an offer to purchase Debtor's assets. He also indicated that CVC had purchased Papercraft notes, including those held by the RTC. This was the first time that CVC informed the creditors' committee

that it intended to make an asset purchase offer. It also was CVC's first communication or confirmation to the committee of the fact that CVC had purchased notes.[3]

41. Shortly before September 13, 1991, Muqaddam provided drafts of an asset purchase agreement to Debtor for its review and comment.

42. CVC made its asset purchase offer in a letter to Debtor dated September 13, 1991. BNYCC had agreed to provide financing.

43. On October 15, 1991, Debtor filed an amended version of the BDK Plan which was further amended on subsequent occasions.

44. Debtor also filed a second plan, the CVC Plan, at CVC's suggestion, on October 15, 1991. CVC's asset purchase offer formed the cornerstone of the CVC Plan. CVC consented to the use of its asset purchase offer in the CVC Plan.

45. Debtor filed a disclosure statement for the Amended BDK Plan on October 15, 1991, and a disclosure statement for the CVC Plan on the same date.

46. The court approved the BDK disclosure statement on December 17, 1991.

47. CVC filed objections to confirmation of the Amended BDK Plan on January 14, 1992, because the creditors' committee did not agree to CVC's claim based on the face amount of the notes. The plan was confirmed on January 21, 1992.

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[3] In his pretrial declaration, Muqaddam states that "CVC made formal disclosure to entities that were members of the Creditors' Committee much earlier" than September of 1991. Defendant's Pre-Trial Evidentiary Submission, Declaration of M. Saleem Muqaddam, Docket Entry 122. However, we do not credit his statement. The weight of other testimony and all of the credible evidence establishes that this did not occur.

> 48. Debtor retained the exclusive right to file a plan from the date of the filing of the bankruptcy through the plan confirmation.
>
> 49. When purchasing claims, CVC did so through brokers which resulted in CVC's identity not being revealed.[4]

For the reasons which follow, we find that CVC's nondisclosure of its claims purchases was inappropriate and we adopt a per se rule against "insider trading" in bankruptcy cases absent pre-purchase disclosure of the insider's identity, connection to the debtor, and nature of the activity. CVC is an insider by definition under the Bankruptcy Code. *11 U.S.C. § 101*(31)(B). In our prior opinion we analyzed in detail CVC's insider status by virtue of its relationship with Muqaddam and Amalgamated. See *In re Papercraft Corporation, 165 Bankr. 980, 987 & n.12 (Bankr.W.D.Pa. 1994).* We repeat that analysis here.

The Bankruptcy Code defines an insider of a corporate debtor as including

> directors, officers of the debtor, persons in control of the debtor and other entities not relevant to the issue herein.[5]

*11 U.S.C. § 101*(31)(B). Although there are numerous bankruptcy court decisions regarding who an insider might be, few courts of appeals have passed on the question. Those which have addressed the issue agree that use of the word

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[4] CVC switched brokers, from Citicorp Securities Markets, Inc., to UBS Securities, when Citicorp Securities had been unsuccessful in obtaining the notes held by the RTC for CVC.

[5] "Person" is defined as including corporations. *11 U.S.C. § 101*(41). However, CVC is not "in control of" Debtor insofar as it lacks voting stock. To the extent that it had its representative (Muqaddam) on Debtor's board CVC had influence but alone could not control Debtor's day-to-day functioning.

"includes" in defining "insider" suggests an expansive interpretation of the term rather than a limited one. See *Matter of Holloway, 955 F.2d 1008 (5th Cir. 1992)* (rehearing denied); *Matter of Newcomb, 744 F.2d 621, 625 n.4 (8th Cir. 1984); Matter of Missionary Baptist Foundation of America, Inc., 712 F.2d 206, 210 (5th Cir. 1983).* The unrestricted view of the definition of insider is based on legislative history. *In re Missionary Baptist Foundation of America, Inc., 712 F.2d at 210.* That history teaches that an insider "is an entity or person with a 'sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.'" Id., citing S.Rep. No. 95-989, 95th Cong., 2d Sess. See also *Matter of Holloway, 955 F.2d at 1010; Matter of Newcomb, 744 F.2d at 625, n.4.* What constitutes a "sufficiently close relationship with the debtor" is a question of fact. Cf., *Matter of Holloway, 955 F.2d at 1014* ("the determination of insider status is a question of fact").

We find that the facts establish that CVC had a "sufficiently close relationship" with Debtor to constitute CVC a statutory insider.[6] Through its equity position in

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[6] Cases finding insider status of those not specifically identified in § 101 include In re Holloway, 955 F.2d 1008 (5th Cir. 1992) (divorced spouses); In re Tanner, 145 Bankr. 672 (Bankr.W.D.Wash. 1992) (lovers); In re Standard Stores, Inc., 124 Bankr. 318 (Bankr.C.D.Cal. 1991) (corporate debtor's president's ex-brother-in-law); In re O'Connell, 119 Bankr. 311 (Bankr.M.D.Fla. 1990) (friend who made several informal loans to the debtor); In re Ribcke, 64 Bankr. 663 (Bankr.D.Md. 1986) (parents of debtor's deceased wife); Matter of Montanino, 15 Bankr. 307 (Bankr.D.N.J. 1981) (parents of debtor's live-in fiance).

Financial power over the debtor may be insufficient in and of itself to make an entity an insider. *In re Torcise, 146 Bankr. 303 (Bankr.S.D.Fla. 1992),* held that, in order for a bank or its officers to be insiders in a preference action, they must have "unreasonable control" over the debtor or the debtor must have become the bank's alter ego or instrument. Cf. *In re Polk, 125 Bankr. 293 (Bankr.D.Colo. 1991)* (the degree of control). While this court will not go so far as to find that control, reasonable or

Amalgamated, Debtor's affiliate, *11 U.S.C. § 101*(2), CVC controlled, prepetition, at least one seat on the boards of directors of Amalgamated, Debtor, and Debtor's principal subsidiaries. These seats were occupied by CVC's vice president, Muqaddam. Deposition of M. Saleem Muqaddam at 17-18, 21 (hereafter "Muqaddam Deposition"). Through Muqaddam's position on Debtor's board, CVC had access to financial information with respect to Debtor and its reorganization plans. Furthermore, CVC took part in various business decisions concerning Debtor, and was in a strategic position regarding Debtor's restructuring and reorganization. Muqaddam was on Debtor's board because Pennsylvania law requires that corporate directors be natural persons. 15 Pa. Cons. Stat. Ann. § 1722. Thus, CVC itself could not serve as a director of Debtor and, instead, placed on Debtor's board[7]

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otherwise, is the only test of insider status, we agree that control is one of many factors to consider in determining insider status. In this case CVC had Muqaddam, its officer and one of Debtor's directors, as its instrumentality. Muqaddam acted for CVC's benefit and on its behalf. Through Muqaddam CVC achieved its insider status. Through Muqaddam CVC was a de facto director and therefore was in a position to exercise some control.

[7] As a matter of law, Muqaddam was CVC's agent and, under the doctrine of respondeat superior, CVC is liable for Muqaddam's breach of fiduciary duty. See § V, Fiduciary Duty, infra. CVC "knowingly permit [ted] its agent", Muqaddam, to purchase claims against Debtor, authorized his actions and provided him with the authority and the means to accomplish the purchase. *Moss v. Elan Memorial Park Corp., 400 Pa. Super. 555, 583 A.2d 1254, 1257 (Pa. Super. 1990).* CVC expressly granted to Muqaddam the power and funds with which to purchase the claims and so is bound by Muqaddam's actions. See *Lokay v. Lehigh Valley Co-op. Farmers, Inc., 342 Pa. Super. 89, 492 A.2d 405, 409 (Pa. Super. 1985).* Muqaddam was acting within the scope of his employment with CVC in purchasing the claims and his conduct was in furtherance of CVC's business inasmuch as he was charged with the responsibility of monitoring CVC's investments and ensuring their aggrandizement. Pennsylvania law dictates that under these circumstances CVC is liable for Muqaddam's conduct. See *Johnson v. Glenn Sand and Gravel, 308 Pa. Super. 22, 453 A.2d 1048, 1050 (Pa. Super. 1982)* (tort liability).

Muqaddam as its representative. Muqaddam testified that his duties as an employee of CVC include investing on CVC's behalf. Muqaddam Deposition at 6. He acknowledged in his deposition that he served on Debtor's board on behalf of CVC and that he acted as a director of Debtor with CVC's best interests in mind. As a vice president of CVC, Muqaddam was responsible for acquiring and monitoring CVC's investment in Debtor and related entities. Muqaddam Deposition at 11-13, 153.

Muqaddam, while on Debtor's board, approached CVC with the proposition that CVC purchase claims against Debtor. CVC then authorized the purchases and provided the funds. Financial projections for two of Debtor's subsidiaries, Barth & Dreyfuss and Knomark, were prepared to assist the committee by the committee's financial advisor, Chanin and Company. The committee shared that information with Debtor. Without the committee's knowledge or consent, it was then given to Muqaddam by Debtor's senior management to assist CVC in constructing an asset purchase offer. Debtor assisted in modifying the projections at Muqaddam's request because he was a director of Debtor. The modifications were made with information obtained by CVC through a site visit to the subsidiaries by Cournoyer and Havgestad. These modified projections, although part of Debtor's records, were never provided to the committee, its counsel, or its financial advisor. Muqaddam evaluated the subsidiaries and knew that the price range at which their acquisition would be made would be below the potential economic values of the companies. He expected CVC to make a profit based on the valuation of the notes CVC intended to purchase. Muqaddam Deposition at 93, 218-19.

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In fact, CVC's liability would exist even if Muqaddam was only partially motivated by a desire to serve CVC's interests. *Shuman Estate v. Weber, 276 Pa. Super. 209, 419 A.2d 169, 173 (Pa. Super. 1980).*

Frank T. Kane, Debtor's former chief financial officer, testified that financial projections prepared by or for Debtor in connection with the bankruptcy were modified at the request of Muqaddam or a member of his staff with reference toward CVC's proposed asset purchase. Deposition of Frank T. Kane, April 10, 1992, at 80-81 (hereafter "Kane Deposition"). Although the projections were a part of Debtor's records, they were never provided to Chanin & Company, any member of the creditors' committee, or to its counsel. Kane Deposition at 81.[8] Thus, even if, as CVC argues, all Debtor's records were in the public domain by virtue of the bankruptcy, the records constitute inside information when their existence is not disclosed except to insiders.

It is the access to the inside information that renders trading in claims particularly dangerous in a bankruptcy situation. *Wolf v. Weinstein, 372 U.S. at 642.* CVC had virtually unrestricted access to inside information and significant assistance from Debtor through its employees and staff and its control over its subsidiaries. Muqaddam admitted at trial that prepetition he had been approached to buy Papercraft notes but refused because he had inside information at that time. In his view, postpetition, all financial information was on the public record and, therefore,

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[8] Although projections were provided to the creditors' committee, they apparently were not the same as those contained in the modifications provided to CVC. Kane Deposition at 80-88. CVC also requested, and was provided, projections of monthly working capital and income distribution but Kane was not sure if the numbers used were those based on CVC's assumptions or if the information was based on Debtor's projections. Id. at 85. However, Kane also testified that Muqaddam "or one of his representatives" had asked for "a monthly model for an income statement, balance sheet and cash flow to disclose to [CVC] the working capital changes and income statement movement within a prescribed period of time," id. at 87, with respect to Barth and Dreyfuss in order to determine that company's seasonal credit requirements. Id. at 88.

he considered himself not to be an insider. Contrary to his assertion, the evidence established that all of the information was not of record at the time he received it. Moreover, the committee did not know that Debtor prepared information for and gave it to Muqaddam, at his request, because he was a director of Debtor and which, in turn, Muqaddam used to further CVC's corporate interests.

Even if all of the information had been on the public record, that fact would not have changed CVC's insider status. Moreover, nothing in the Bankruptcy Code indicates that an entity's insider status is abrogated because some or all of Debtor's financial information becomes public. Insider status is a function of an entity's relationship to the debtor and/or to other insiders. See. e.g., *11 U.S.C. § 101*(31)(B) ("'insider' includes . . . (B) if the debtor is a corporation — (i) director of the debtor . . . or (vi) relative of a . . . director, officer or person in control of the debtor"). Insider status is not a function of what, if any, financial information Debtor publicizes. Although the committee had access to Debtor's records, it was not in a position similar to CVC's with respect to information about Debtor. CVC, as a member of Debtor's board, engaged in various business decisions affecting Debtor and was in a strategic and unique position regarding Debtor's restructuring and reorganization.

In this case, CVC, through Muqaddam, had an advantage available only to insiders. When requests for information were made of Debtor by parties in interest in this case the testimony was undisputed that Muqaddam's requests always received priority treatment because of his position.

In deposition, William T. Comfort, chairman of the board of directors of CVC and a member of the investment committee that approved CVC's note purchases, testified that CVC invested in the Papercraft notes to preserve CVC's reputation. He explained that if an entity in CVC's position is seen to abandon one of its flock in distress, the company

loses some of its credibility in the marketplace. He further testified that a secondary consideration was a return on CVC's investment. Deposition of William Comfort at 31, 36 (hereafter "Comfort Deposition"). His testimony does not fit squarely with that of Michael Arnold, who was Debtor's president and the CEO of Debtor, its subsidiaries and Amalgamated and held a seat on Amalgamated's board of directors. Mr. Arnold stated that in January or February of 1991, he first became aware that CVC was analyzing Barth & Dreyfuss to determine whether a purchase offer would be a possibility. Deposition of Michael Arnold at 63-64 (hereafter "Arnold Deposition"). By letter dated October 4, 1991, from Muqaddam addressed to him, Arnold learned that CVC held claims and was informed that CVC would vote to reject a plan that did not pay it in full. Id. at 139. We credit Mr. Arnold whose statement somewhat belies Comfort's assertion that CVC's conduct was only secondarily motivated by its desire for profit. What is consistent in both witnesses' testimony is that CVC intended to enhance CVC's goals, by protecting its reputation and/or by adding to its profits, even if that goal conflicted with Debtor's negotiated reorganization.

CVC's defense is further undermined by inconsistencies in Muqaddam's trial, deposition, and declaration testimony. For instance, in its pretrial evidentiary submission, CVC presented a declaration by Muqaddam in which he stated that he believed that he had not requested Chanin and Company's enterprise valuation and its distressed sale analysis. At trial Muqaddam stated that he had asked for the information to illustrate the fairness of CVC's asset purchase offer. In his deposition given in connection with the committee's motion for partial summary judgment, Muqaddam stated that he had not sought the advice of counsel concerning the purchase of papercraft notes. Muqaddam Deposition at 90. At trial Muqaddam stated that had he consulted with a law firm concerning whether CVC

could make the purchase and the propriety of the purchase, but his inquiry was only an informal request concerning regulatory matters.

At trial Muqaddam denied that CVC's particular goal was to purchase the Papercraft notes held by the RTC. In his deposition given in connection with the motion for partial summary judgment, however, he testified that one goal was to buy the RTC notes because he feared another entity, such as Second Pennsylvania, would do so, thereby disrupting, or attaining a position from which to disrupt, the reorganization process. In addition to these inconsistencies in testimony, the court took particular note of Muqaddam's demeanor at trial. On the witness stand, Muqaddam perspired heavily in an air conditioned room and drank huge quantities of water. He is a sophisticated businessman accustomed to pressure but he exhibited extraordinary nervousness given the circumstances. We find from the evidence as a whole that CVC's intention was to benefit from its position as a director of Debtor by purchasing claims at a discount.

CVC tries to excuse its failure to disclose its identity and insider position based on evidence that, in April of 1991, the committee had knowledge of a rumor that CVC had purchased some notes. The fact and/or extent of the committee's knowledge is not controlling. CVC, as an insider of Debtor, had an obligation to formally disclose its identity and status as an insider to the sellers, Debtor, and the committee prior to purchasing claims during the bankruptcy. CVC did not disclose its identity to Debtor or the committee before it purchased the notes and never disclosed its identity or its seat on Debtor's board of directors to the sellers. The purchases gave CVC voting control over Class 4, an impaired class of general unsecured creditors under the BDK plan. CVC held no claims against Debtor prepetition

but during the period between April 1, 1991, and August 30, 1991, obtained 40 percent of all outstanding notes, thereby gaining the ability to control the voting in its class on a reorganization plan.

CVC never cast a vote for or against the plan. As it was, although it had voted in favor of the BDK plan concept prepetition, CVC filed objections to the BDK plan which were not withdrawn until it was promised a seat on the board of the reorganized debtor and certain distribution language was changed in the plan. Without the withdrawal of CVC's objections (or some form of disenfranchisement of its voting rights), it was questionable whether the BDK plan could be confirmed as fair and equitable because of the 40 percent interest CVC acquired during the case. As a further result of the purchases, CVC was in a position to gain a profit under the confirmed plan of approximately $5.4 million if its claims were allowed in amounts equal to the face value of the notes.

Because of CVC's postpetition interest acquired in Debtor, a second plan of reorganization, the CVC plan, was filed. The BDK plan had provided for formation of a new company by merger of some of the subsidiaries, a stock for debt exchange, and certain cash payments. The CVC plan essentially was a cash offer by CVC to buy certain assets and operating subsidiaries of Debtor without acquiring certain associated liabilities. CVC's undisclosed claims purchases facilitated this turn of events. Its conduct created litigation that would not have been needed otherwise and was an impropriety, if not actual wrongdoing, that cannot be countenanced.

CVC's conduct falls within the "vulture investor" category. See Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor, 48 Bus. Law. 915, 924 (May 1993) (hereafter "Vultures Beware").

> The typical modus operandi of a vulture investor is to purchase trade claims, bank debt, or other securities at a discount from the face amount, and often to purchase sufficient voting power to enable the vulture investor to block confirmation of any plan of reorganization proposed for the debtor that the vulture investor does not like.

Id. at 916 (footnote omitted).

> Vulture investors may control the terms for the reorganization of a debtor in chapter 11 by means of the purchase at bargain prices of a blocking vote position in a significant debt class. This could enable a vulture investor to dictate the terms of the reorganization, which could result in very large rewards for the investor. The reason that vulture investors are able to reap such large returns is that some chapter 11 debtors end up in chapter 11 not so much because their businesses have gone bad, but because of the leveraged debt that they could not shoulder . . . The result can [have] . . . the vulture ending up with the dominant ownership position in a good business, after having paid a bargain price for a debt position which merely served as a means to acquire the debtor's business through the vehicle of chapter 11.

Id. at 917 (footnote omitted). This is precisely the conduct in which CVC engaged and which cannot be tolerated in fiduciaries in a bankruptcy case. CVC's status as an insider, whether or not it used inside information, precluded the sellers from making a fully informed assessment of the consequences of selling their claims and thereby deprived them of the opportunity to make an informed decision regarding the sale.

A member of a board of directors holds a fiduciary duty "to promote the interests of the corporation." *United States v. Byrum, 408 U.S. 125, 138, 33 L. Ed. 2d 238, 92 S. Ct. 2382,*

rehearing denied, *409 U.S. 898, 34 L. Ed. 2d 157, 93 S. Ct. 94 (1972)*. In this instance CVC used its position on Debtor's board to further its own interests — it sought to salvage or enhance its reputation and it sought a profit for itself. The credible evidence supports the conclusion that, while it served as a director of Debtor, CVC acted in furtherance of CVC's interests.

Furthermore, corporate directors bear "the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession." See *Commodities Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355, 85 L. Ed. 2d 372, 105 S. Ct. 1986 (1985)*. See also *Wolf v. Weinstein, 372 U.S. 633, 649, 10 L. Ed. 2d 33, 83 S. Ct. 969*, rehearing denied, *373 U.S. 928, 10 L. Ed. 2d 427, 83 S. Ct. 1522 (1963)*. Upon insolvency of the corporation, the director's fiduciary duty extends to the corporation's creditors and is enforceable by the trustee.[9] See *Pepper v. Litton, 308 U.S. 295, 307, 84 L. Ed. 281, 60 S. Ct. 238 (1939); Brown v. Presbyterian Ministers Fund, 484 F.2d 998, 1005 (3d Cir. 1973)*. In this case Muqaddam utilized his position on Debtor's board to advance CVC's interests. He did not carry out his fiduciary obligation to act in the best interests of Debtor and its estate.

Although directors may purchase claims against their corporation when the corporation is solvent, they are not entitled to do so at a discount and enforce the claims at full value when the corporation is insolvent or has filed bankruptcy. *In re Bridgford Co., 237 F.2d 182, 185 (9th Cir. 1956)*, cert. denied *Bridgford v. Sampsell, 352 U.S. 1005, 1 L. Ed. 2d 550, 77 S. Ct. 566 (1957)*. See also *Manufacturers Trust Co. v. Becker, 338 U.S. 304, 313-14, 94 L. Ed. 107, 70*

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[9] Moreover, "a creditors' committee . . . may raise and may appear and may be heard on any issue in a case under" chapter 11. *11 U.S.C. § 1109*(b).

*S. Ct. 127 (1949); Monroe v. Scofield, 135 F.2d 725 (10th Cir. 1943); In re UVAS Farming Corp., 91 Bankr. 575, 577 (Bankr.D.N.M. 1988)* (when a director purchases claims against its corporation in bankruptcy, recovery is limited to the amount paid for the claim). This is not a situation where a Chinese wall was implemented with policies and procedures effective to prevent the misuse of nonpublic information, see *In re Federated Dept. Stores. Inc., 1991 Bankr. LEXIS 288, 1991 WL 79143* (Bankr.S.D.Ohio, March 7, 1991), nor was it an arm's length transaction and the bankruptcy court is not required to treat these claims equally with those of other creditors. See *Pepper v. Litton, 308 U.S. 295, 306-07, 84 L. Ed. 281, 60 S. Ct. 238 (1939).*

The availability of claims for purchase at a discount pursuant to a bankruptcy constitutes a corporate opportunity. *Brown v. Presbyterian Ministers Fund, 484 F.2d 998, 1004 (3d Cir. 1973).* Absent a bankruptcy case, a director may use the opportunity if the director discloses to shareholders, the shareholders consent, and the use of the corporate opportunity by the director is not detrimental to the corporation. *CST, Inc. v. Mark, 360 Pa. Super. 303, 520 A.2d 469, 471* (Pa. Super.), appeal denied, *539 A.2d 811 (Pa. 1987).* See also *Robinson v. Brier, 412 Pa. 255, 194 A.2d 204, 206, 208 (Pa. 1963).* A director who purchases claims without first providing the debtor with the opportunity to make the purchases violates his fiduciary duty. See, e.g., *In re Cumberland Farms, Inc., 181 Bankr. 678 (Bankr.D.Mass. 1995).*

Even when purchasing claims against a solvent corporation, a director has a heavy burden to establish the fairness of the conduct. *Robinson v. Brier, 194 A.2d at 206.* Appropriation of corporate opportunities by a fiduciary of an insolvent entity, even with approval of the shareholders,

directors, and officers, is impermissible when it results in a detriment to creditors. *Brown v. Presbyterian Ministers Fund, 484 F.2d at 1005.*

Detriment is a relative term. In this case, at least three adverse effects are identifiable. The first befell the selling noteholders who, at the time of sale, were creditors of Debtor and were deprived of the ability to make a fully informed decision concerning the sale of their claims. If, after full disclosure, they had elected not to sell, they would have received a total distribution of $15,989,676.56 under the plan rather than the amount paid by CVC of $10,553,541.88, a difference of more than $5.4 million. Of course, they may have elected to sell after full disclosure, in which event the court would not be left to second guess their business choices. The harm lies in the fact that the selling noteholders had no opportunity to consider pertinent information.

The second is that CVC's actions diluted the voting rights of prepetition creditors[10] and resulted in CVC's attempt to wrest from the prepetition creditors the valuable assets of Debtor. Lack of disclosure

> has two effects. First, it is detrimental to the efficiency of the market for claims. An efficient market requires that both the buyer and the seller have access to information so that each party to the transaction can be adequately informed. Under Bankruptcy Rule 3001(e), as amended, large sophisticated purchasers of claims, who have the resources and incentives to closely monitor a chapter 11 case, have more information

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[10] CVC did not vote its claims. Nonetheless, its acquisition of claims placed it in the controlling seat in its class and, but for the creditors' committee's actions to contest CVC's claims, we are again left to speculate as to whether CVC would have voted. CVC's non-vote does not nullify the need for a per se rule. Absent a per se rule, CVC would still profit from its purchases of claims monetarily and/or in its enhanced reputation and similar conduct would not be deterred.

> regarding the value of a claim than a small trade creditor, and the small trade creditor has no reasonable means to acquire that information. Second, because only the name of the transferee of record need be disclosed, parties in interest will be unable to ascertain who the real claims buyer is and the intentions of that claims buyer with respect to the control of a debtor.

Joy Flowers Conti, Raymond F. Kozlowski, Jr., Leonard S. Ferleger, Claims Trafficking in Chapter 11 — Has the Pendulum Swung Too Far?, 9 BANKRUPTCY DEVELOPMENTS JOURNAL # 2, at 300 (1992) (hereafter Claims Trafficking) (footnotes omitted).

The third is that, by purchasing, CVC put itself in a position of having a conflict of interest by jeopardizing its ability

> to make future decisions on claims as a director free of [its] own personal interests as owner of claims. Adding to the conflict is the fact these purchases were made at a discount from present value. This brings into play a profit motive, accentuating [its] personal interests.

*In re Cumberland Farms, Inc., 181 Bankr. at 680* (citations omitted).

The filing of a bankruptcy creates a private market in securities and CVC's protestations that its failure to disclose constituted "normal market protocol" are unpersuasive. "Corporations in bankruptcy are treated differently from solvent corporations"). *Commodity Futures Trading Comm'n. v. Weintraub, 471 U.S. 343, 357, 85 L. Ed. 2d 372, 105 S. Ct. 1986 (1985).* The evidence established that Debtor was insolvent in an equity sense at confirmation. In that circumstance, "the purchase by a director of claims against his own corporation . . ., particularly the purchase of claims at a discount, places too much strain upon the loyalties of the director." *In re Cumberland Farms, Inc., 181 Bankr.*

*at 680.* A director of a corporation in bankruptcy should have no conflicting interest in dealings on behalf of the corporation with those holding claims against it.

The evidence also established that CVC intended to gain influence over the case. Comfort Deposition at 143 (Comfort stated that the note purchases by CVC would put it in a position "to help influence something"). Without disclosure by insiders of their trading in claims, creditors are at risk of selling claims "at extraordinary discounts, without understanding their rights". *In re Allegheny Int'l., Inc., 100 Bankr. 241, 242 (Bankr.W.D.Pa. 1988)* (footnote omitted).

"Disclosure is fundamental in a bankruptcy case." Claims Trafficking, *9 BANKR. DEV. J. at 302.* "The interest of sellers in having adequate information available for them to make an informed decision and the interest of nonsellers who may find themselves controlled by a third party whose intent would be to minimize the value that goes to the nonsellers are the two interests that need to be protected in control contests." *Id. at 304.* Several provisions of the Bankruptcy Code are grounded in the concept of disclosure. For example, a debtor must disclose all of its assets and liabilities. See *11 U.S.C. § 521* (debtor must file schedule of assets and liabilities); § 101(12) ("'debt' means liability on a claim"), (5) ("'claim' means (A) right to payment, whether or not such right is . . . contingent"; Fed.R.Bankr.P. 1007. A proof of claim filed by a creditor must identify the nature of the claim and include supporting documentation if it exists. *11 U.S.C. § § 501,* 502; Fed.R.Bankr.P. 3001. In order for a plan of reorganization to be confirmed, a disclosure statement containing "adequate information" must be approved by the court. *11 U.S.C. § 1125.* Disclosure is equally as significant in the context of claims trading by a trader who is an insider and a fiduciary, who owes a duty of loyalty to

the debtor, and who is bound to avoid a conflict of interest. *Wolf v. Weinstein, 372 U.S. 633, 10 L. Ed. 2d 33, 83 S. Ct. 969 (1963).*

This situation lacks an essential earmark of an arm's length transaction (i.e., disclosure of relevant information) and was inherently unfair to the selling noteholders and prepetition creditors because of the lack of appropriate notice. We are required to "sift the circumstances surrounding any claim to ensure that injustice or unfairness to creditors does not occur in administration of the bankrupt estate." *In re Allegheny Int'l., Inc., 118 Bankr. 282, 302 (Bankr.W.D.Pa. 1990),* citing *Pepper v. Litton, 308 U.S. at 307-08.* See also *In re Allegheny Int'l., Inc., 100 Bankr. 241 (Bankr.W.D.Pa. 1988); Matter of Executive Office Centers, Inc., 96 Bankr. 642, 649-50 (Bankr.E.D. La. 1988); In re UVAS Farming Corp., 91 Bankr. 575 (Bankr.D.N.M. 1988).* In this case, unfairness caused by CVC's conduct would not be adequately addressed absent application of a per se rule.

The usual remedy for the improper purchase of claims at a discount by a fiduciary is to subordinate or disallow the fiduciary's claim to the extent its face amount exceeds the amount paid. See *In re Norcor Mfg. Co., 109 F.2d 407* (7th Cir.), cert. denied *310 U.S. 625, 60 S. Ct. 898, 84 L. Ed. 1396 (1940).* See also *In re Philadelphia & Western Ry. Co., 64 F. Supp. 738 (E.D.Pa. 1946).* We have disallowed CVC's claim to the extent that it exceeds the purchase price.

Notwithstanding the foregoing, we find that equitable subordination of CVC's claims is not appropriate. There was insufficient evidence to establish that CVC purchased claims with the intent to harm Debtor or defraud its creditors, despite the result. Although misconduct or wrongdoing is not always a prerequisite for subordinating a claim,[11]

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[11] See *In re Burden, 917 F.2d 115, 120 (3d Cir. 1990)* (regarding nonpecuniary tax penalty).

subordination must be considered on a case by case basis with due regard to the equities of the particular case. *In re Burden, 917 F.2d 115, 120 & n.14 (3d Cir. 1990).* The burden of proof with respect to equitable subordination in the case of insiders or fiduciaries has been articulated as the burden of "presenting material evidence of unfair conduct". *In re Nutri/System of Florid.: Associates, 178 Bankr. 645, 657 (E.D.Pa. 1995).* That burden rests with the committee in this case. Once that burden is met, the insider must prove that its transactions with the debtor were fair. Other than conduct by an insider or fiduciary, the burden is to prove that fraud or other culpable conduct occurred. Id.

The committee contends that the creditors were harmed because Debtor's filing of the BDK disclosure statement was deliberately delayed by CVC to enable it to purchase claims and make the asset purchase offer. The committee asserts that CVC's claim should be equitably subordinated. CVC contends that the delay was occasioned by (1) the litigiousness of Debtor's landlord, Second Pennsylvania Real Estate Corporation and (2) because financial information concerning one of the subsidiaries, American Technical Industries, Inc., (hereafter "ATI"), was not complete, causing indecision as to whether to include ATI in the plan and the tax ramifications of including ATI. CVC contends that until all information was collected and the tax ramifications were examined, the BDK disclosure statement could not be completed.

Regarding the landlord's claims, the record reflects that the Second Pennsylvania litigation required much of Debtor's counsel's time as well as much court time. Nonetheless, although a disclosure statement could have been structured to account for Second Pennsylvania's claim despite the litigation, Debtor chose not to do so.

Regarding the ATI issue, the record reflects that this matter was an important one which affected Debtor's restructuring proposal, although we note that Debtor filed its plan without a disclosure statement three days after it filed this bankruptcy. Thus, some consideration had already been given to the ATI issue or Debtor could not have proposed its plan.

As this bankruptcy progressed, this court approved extensions of Debtor's exclusive period at Debtor's request because we found, with each request, cause for extension. There was no evidence that CVC engaged in conduct designed to delay the plan process. The evidence showed only that during the delay between the filing of the case and the filing of the disclosure statements CVC was active in its own interests in derogation of its fiduciary responsibility toward Debtor and its estate.

Subordination of claims is appropriate only to the extent necessary to offset any harm to the debtor or other creditors on account of the untoward conduct. *In re Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977).* Mobile Steel established a threefold test for the propriety of equitable subordination. There must be (1) inequitable conduct which (2) caused injury to creditors or the debtor or resulted in an unfair advantage to the creditor whose claim is sought to be equitably subordinated and (3) equitable subordination must be consistent with the *Bankruptcy Code. 692 F.2d at 700.* In the instant case we find that the first two standards have been met but, because of our limitation on the allowance of CVC's claims, equitable subordination is not consistent with the Code. We have previously held that "principles of fairness would be violated if insiders who create an unfair advantage for themselves were permitted to share equally with other creditors." *In re I.D. Craig Service Corp., 1991 WL 155750* at *7 (Bankr.W.D.Pa., August 8, 1991). Because we are limiting the allowed amount of CVC's claim to the

amount it paid for the claims, with recovery under the plan gauged to that amount, we have adhered to principles of fairness without the necessity of subordinating CVC's claim. The limitation of recovery removes CVC's profit, discourages similar future conduct and provides a recovery on the claims of creditors in CVC's class which is greater than they would have had absent this limitation. It also removes any economic advantage CVC gained over other insiders who honored their duties and did not purchase claims without the appropriate disclosures. Under these circumstances, equitable subordination of CVC's entire claim is not warranted on the evidence in this case. Therefore, we will deny the committee's request' for equitable subordination.

By limiting CVC's recovery to the plan percentage as applied to the amount CVC paid for the claims we create a disincentive for insiders to trade in claims without prior disclosure to the sellers, buyers, debtor and creditors involved. It may be that, under some circumstances, non-disclosure will not subject to censure an insider who purchases claims. See, e.g., *In re Federated Dept. Stores, Inc., 1991 Bankr. LEXIS 288, 1991 WL 79143* (Bankr.S.D.Ohio, March 7, 1991) (procedures to safeguard various interests). This is not such a case.

An appropriate Order will be entered.

Judith K. Fitzgerald

United States Bankruptcy Judge

DATED: October 12, 1995

**JUDGMENT ORDER**

And now, to-wit, this **12th** day of **October, 1995,** for the reasons set forth in the foregoing Memorandum Opinion, it is **ORDERED, ADJUDGED AND DECREED** that judgment is entered in favor of plaintiff and against defendant on its First Claim For Relief in that the allowed amount of the

claims held by Citicorp Venture Capital, Ltd., is limited to the cost of acquisition and distribution on the claims is controlled by the confirmed Chapter 11 plan. Judgment is entered in favor of defendant and against plaintiff on The Second Claim For Relief seeking equitable subordination and said Second Claim is dismissed with prejudice.

**IT IS FURTHER ORDERED** that the Order dated April 22, 1994, granting partial summary judgment **IS VACATED** and the accompanying opinion is withdrawn

The Clerk shall close this adversary.

Judith K. Fitzgerald

United States Bankruptcy Judge

**LEXSEE 1994 Bankr. LEXIS 597**

**In Re: PAPERCRAFT CORPORATION, a Pennsylvania corporation, Debtor(s); COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AND COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, AS ESTATE REPRESENTATIVE OF PAPERCRAFT CORPORATION, Plaintiff v. CITICORP VENTURE CAPITAL, LTD., a New York corporation, Defendant**

**Bankruptcy No. 91-20903 JKF Chapter 11, Adversary No. 91-2642**

**UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA**

***165 B.R. 980; 1994 Bankr. LEXIS 597; Bankr. L. Rep. (CCH) P75,905***

**April 22, 1994, Decided**

**COUNSEL:**

Philip E. Beard, Esq., Stephan M. Ray, Esq., Counsel for Plaintiffs.

Paul K. Vey, Esq., William Pietragallo, II, Esq., George J. Wade, Esq., Terri Brady, Esq., Counsel for Defendant.

**JUDGES:**

Fitzgerald

**OPINION BY:**

JUDITH K. FITZGERALD

**OPINION:**

## MEMORANDUM OPINION

I. Introduction

The matter before the court is a motion for partial summary judgment on an objection to claims filed on behalf of the Committee of Creditors Holding Unsecured Claims and the Committee in its separate post confirmation capacity as representative of the estate of Papercraft Corporation (hereafter "Committee" and "Debtor" respectively). Pursuant to *11 U.S.C. § 502*(b)(1), the Committee seeks to limit "the allowance of the claims" held by Citicorp Venture Capital, Ltd. (hereafter "CVC"), "to no more than the sum CVC actually paid for such claims." Motion for Partial Summary Judgment, Adversary No. 91-0642 at 1. Post petition, CVC purchased first and second priority notes on the secondary market and filed a claim for their face value. The allowance of the claim at the amount CVC paid would result in a distribution to CVC through the confirmed plan of reorganization (hereafter "the BDK Plan") of less than it expended to purchase the claim. Allowance at face value would result in a profit to CVC of nearly $5.5 million. A third alternative is to limit the plan distribution to CVC without disturbing the allowed amount of its claim.

A bankruptcy court may enter summary judgment "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c); Fed. R. Bankr. P. 7056. We find that this action is appropriate for disposition by summary judgment as there is no dispute of any relevant, material fact. Both parties are in agreement as to the following material facts:

(1) prepetition, CVC held no direct interests in or claims against Debtor.

(2) postpetition, while Debtor was insolvent, CVC purchased notes of Debtor with a face value[1] of $60,849,299.10. Deposition of M. Saleem Muqaddam at 156-61 (hereafter Muqaddam Deposition); Plaintiff's Exhibit 8.

(3) CVC's cost for the notes was $10,553,541.88. Id.

(4) If the claims purchased by CVC are allowed at the face value of the notes, payments to CVC under Debtor's confirmed Chapter 11 plan would result in a profit of nearly $5.5 million to CVC.[2] Declaration of Samuel M. Victor in Support of Motion for Partial Summary Judgment at P 11.

(5) M. Saleem Muqaddam, at all times relevant, was a vice president of CVC and a member of the boards of directors of Debtor, Debtor's parent, and Debtor's principal subsidiaries.

The "Face Value" amounts represent the full value, as defined in footnote 1, of First and Second Priority Notes held by CVC. See Muqaddam Deposition at 156-61 and

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[1] Face value includes the actual face value of the notes and any accrued interest up to the date of bankruptcy.

[2] The expected profit is calculated as follows:

| | Face Value | Cents/Dollar | Plan Distribution |
|---|---|---|---|
| First Priority Notes | $ 34,725,575.72 | 33.46 cent | $11,619,177.64 |
| Second Priority Notes | 26,123,723.38 | 16.73 cent | 4,370,498.92 |
| | $ 60,849,299.10 | | $15,989,676.56 |
| | Less Cost to Citicorp | | 10,553,541.88 |
| | Expected Profit | | $5,436,134.68 |

Plaintiff's Exhibit 8. The "Cents/Dollar" distribution factors represent the approximate reorganization value of the notes under the BDK plan which was confirmed by this court. See Declaration of Samuel M. Victor in Support of Motion for Partial Summary Judgment, Motion for Summary Judgment, Exhibit 2 at P 11. (Samuel Victor is the executive vice president and a principal of Chanin & Company, financial advisor to the Committee.) The "Plan Distribution" calculations are estimates of the amount to be distributed under the plan. The "Expected Profit" is based on the estimated distributions under the plan.

The Issues

We are called upon to determine in this core proceeding whether CVC acted in bad faith or breached its fiduciary duties to Debtor and creditors of the estate by using inside information while purchasing its claims and formulating its offer to purchase the assets of Debtor's operating subsidiaries. This opinion constitutes findings of fact and conclusions of law.

Summary of Findings

For the reasons which follow, we find, as a matter of law, that CVC is an insider of Debtor and that its fiduciary duty to Debtor and the estate required, at a minimum, that CVC advise Debtor, Debtor's shareholders, the Committee, and those from whom it purchased its claims of its identity and its connection with Debtor. CVC held its insider status through Muqaddam, CVC's representative on Debtor's board of directors, who is an insider by statutory definition. *11 U.S.C. § 101*(31)(B). Through Muqaddam, CVC was able to purchase claims and had access to inside information, which was unavailable to other buyers or to the sellers, regarding the potential returns on and value of the notes purchased. It is the access to inside information which removes the purchase from the category of arm's length

transactions and results in limitations on insiders' claims being applied to CVC.[3] See *Wolf v. Weinstein, 372 U.S. 633, 10 L. Ed. 2d 33, 83 S. Ct. 969,* rehearing denied, *373 U.S. 928, 10 L. Ed. 2d 427, 83 S. Ct. 1522 (1963).* See also *In re Van Sweringen Co., 119 F.2d 231, 234* (6th Cir.), cert. denied, *314 U.S. 671, 86 L. Ed. 537, 62 S. Ct. 136 (1941)* (a trustee can make no profit from his trust). We hold that because CVC is an insider its distribution through the plan of reorganization is limited to no more than the amount CVC actually paid for the notes it purchased. *In re UVAS Farming Corp., 91 Bankr. 575, 577-78 (Bankr. D.N.M. 1988).* Cf., *In re Van Sweringen Co., 119 F.2d at 234* (purchase of claims of debtor corporations by corporation created by directors of debtors "at substantially less than real values" required that the claims be limited to the amount paid for their acquisition).

Accordingly, the Committee's motion will be granted in that CVC's distribution will be limited to the amount it paid to purchase its claims, without interest.

## II. Background

Debtor filed a voluntary Chapter 11 bankruptcy petition on March 22, 1991, largely as the result of carrying significant debt stemming from a leveraged buyout (hereafter "LBO") in 1985. The LBO, in which CVC was involved, transformed Debtor from a publicly traded company into a

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[3] The federal securities laws have similar restrictions on persons possessing inside information and require disclosure prior to trading a security, absent which trading is prohibited. See Rule 10b-5 of the Securities Exchange Act of 1934. See also Rule 14e-3(a) of that Act concerning tender offers. The policies of disclosure and fairness to the public of the securities and bankruptcy laws are similar. For the case against applying federal securities laws to claims trading in bankruptcy see Anthony M. Sabino, No Security in Bankruptcy: The Argument Against Applying the Federal Securities Laws to the Trading of Claims in Bankruptcy, *23 Pacific L. J. 109 (1992).*

wholly owned subsidiary of its parent, Amalgamated Investment Corporation (hereafter "Amalgamated").[4] Through the LBO, CVC acquired a 28 per cent equity position in Amalgamated which entitled it to a seat on the boards of Amalgamated, Debtor, and Debtor's primary subsidiaries. Muqaddam held those seats, having been nominated by CVC.

During the period from the LBO to the bankruptcy filing, Debtor experienced a decline in business performance and was haunted by its heavy debt burden, resulting in debt restructuring agreements in 1989 and 1990.[5] The 1989 restructuring saw the exchange of approximately 98 per cent of Debtor's debentures for First Priority Notes and Second Priority Notes. See Declaration of Pamela M. Cascioli in Support of Motion for Partial Summary Judgment, Motion for Partial Summary Judgment at Exhibit 1. The 1990 agreement was approved unanimously by Debtor's board of directors, including Muqaddam, and was essentially what became the original BDK Chapter 11 plan of reorganization which Debtor filed on March 25, 1991, just three days after filing this bankruptcy. Its terms had been negotiated with the existing creditors prepetition. On March 22, 1991, the date of the bankruptcy filing, Debtor was liable for $90,717,358.00

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[4] Amalgamated filed a chapter 7 petition in this district on October 17, 1991, at Bankruptcy Number 91-3716. The combined debt of Debtor and Amalgamated exceeded $280 million.

[5] According to the approved Disclosure Statement, Debtor sold substantial assets prepetition, thereby satisfying all but one of its secured debts. The remaining secured claim was approximately $300,000.00. Thus, at the time the bankruptcy was filed, Debtor's obligations to its noteholders were its largest debts. Its other debts included lease rejection and small priority claims, a pension liability which was assumed by Debtor's subsidiaries, and claims of affiliates and stockholders. For further explanation of the claims, see the Transcript of the Plan Confirmation Hearing dated January 21, 1992. The noteholders were all placed in Class 4, the general unsecured class, in the BDK plan.

on First Priority Notes and $56,318,768.00 on Second Priority Notes. On that date CVC held none of Debtor's First or Second Priority Notes.

Within one week of Debtor's bankruptcy filing and just a few days after the BDK plan was filed with Muqaddam's concurrence, Muqaddam obtained approval from CVC to expend in excess of $10,000,000 for the purchase of notes owed by Debtor. Without notifying Debtor[6] or the Committee, and without identifying CVC or its connection with Debtor through Muqaddam to the sellers, Debtor's shareholders, or the Committee, CVC authorized Muqaddam to purchase, on CVC's behalf, a total of $60,849,299.10 of Debtor's First and Second Priority Notes for a total expenditure of $10,553,541.88. See footnote 2 and Exhibit 8.[7] Muqaddam never sought Debtor's approval for the purchase (Muqaddam Deposition at 167), never disclosed to Debtor or the Committee before it purchased (Muqaddam Deposition

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[6] See, e.g. Kane Deposition at 73 wherein Frank Kane, Debtor's former chief financial officer, states that he did not know of the note purchases by CVC until after the fact.

[7] After acquiring the claims and before sending a "letter of interest" dated September 13, 1991, to Debtor's CEO, Michael C. Arnold, regarding forming new corporations to acquire assets and liabilities of certain other companies as part of the plan of reorganization, Muqaddam spoke with Pamela Cascioli, Chairperson of the Committee of Unsecured Creditors, and mentioned that CVC had purchased some notes. Muqaddam Deposition at 379-80. See Exhibit 14, letter dated September 13, 1991, from M. Saleem Muqaddam of CVC to Michael C. Arnold of Debtor. No details were provided, nor was the fact mentioned that CVC's acquisition put it in voting control of its class of creditors. Muqaddam Deposition at 379-80, 382. In a declaration attached to the Committee's Motion for Partial Summary Judgment, Cascioli stated that, before the September 13 letter, "a member of the Committee briefly mentioned ... that ... a member of the [prepetition] Informal Committee, had sold its notes, and a rumor that Citicorp had been the purchaser ...." Motion for Partial Summary Judgment at Exhibit 1, P 7. The discrepancy between Muqaddam's and Cascioli's statements is not material because in neither scenario was the disclosure timely or sufficient.

at 154-55, 167-68), and never disclosed so much as its identity or its relationship on the board of directors to the sellers (Muqaddam Deposition at 165-66). These purchases gave CVC voting control over Class 4, an impaired class of general unsecured claims, in the BDK plan. All trading occurred between April 1, 1991, and August 30, 1991. Through these purchases, CVC, which had no interest in or claims against Debtor prepetition, acquired approximately forty percent of all outstanding notes, thereby gaining the ability to control the voting in its class on a reorganization plan. As a further result of the purchases, CVC was in a position to gain a potential profit under the confirmed plan of approximately $5.4 million if its allowed claim were equal to the face value of the notes.[8] See Footnote 2 and Victor Declaration at P 11.

Although Debtor filed the BDK plan three days after it commenced this case, it did not file an accompanying disclosure statement until October 25, 1991. Thus, the plan confirmation process was stymied. Prior to the confirmation of the BDK Plan and after the purchase of claims by CVC which gave it voting control over a plan, CVC convinced Debtor to take the unusual step of propounding a second, conceptually different plan. Thus, Debtor filed two plans — the previously filed BDK plan and the new CVC plan. The BDK plan essentially provided for a reorganization of Debtor through the formation of a new company by merger, a stock for debt exchange and certain cash payments. The second, "CVC," plan essentially was a cash offer by CVC to buy certain assets and operating subsidiaries of Debtor without acquiring certain associated liabilities. Neither the Debtor nor any other party in interest

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[8] The ability to cause a rejection of the plan through voting control was a significant issue regarding the confirmability of a plan because of the claims structure in this case.

had solicited this offer. Muqaddam Deposition at 120-21. Thereafter, CVC filed objections to the BDK Plan.[9] After certain hearings, Debtor withdrew the CVC plan.

CVC's actions raise the question of whether CVC acquired its position as a noteholder so as to effect a takeover via its status as a "creditor" with voting control and/or to profit from a distribution significantly in excess of its acquisition

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[9] The consequence of this device is not unlike a hostile takeover attempt, albeit one with Debtor's name attached to the alternative plan. See Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor, 48 Bus. Law. 915, 924 (May 1993) (hereafter Vultures Beware).

The factual pattern just described falls within the prototype of "vulture investing" as it appears in Vultures Beware:

> The typical modus operandi of a vulture investor is to purchase trade claims, bank debt, or other securities at a discount from the face amount, and often to purchase sufficient voting power to enable the vulture investor to block confirmation of any plan of reorganization proposed for the debtor that the vulture investor does not like. (Footnote omitted.)

Vultures Beware, *48 Bus. Law. at 916.*

> Vulture investors may control the terms for the reorganization of a debtor in chapter 11 by means of the purchase at bargain prices of a blocking vote position in a significant debt class. This could enable a vulture investor to dictate the terms of the reorganization, which could result in very large rewards for the investor. The reason that vulture investors are able to reap such large returns is that some chapter 11 debtors end up in chapter 11 not so much because their businesses have gone bad, but because of the leveraged debt that they could not shoulder . . . The result can [have] . . . the vulture ending up with the dominant ownership position in a good business, after having paid a bargain price for a debt position which merely served as a means to acquire the debtor's business through the vehicle of chapter 11. (Footnote omitted.)

*Id. at 917.*

cost under the guise of the Bankruptcy Code.[10] CVC did not acquire its claims in the same fashion as the other members of its class, who obtained their claims prepetition without knowledge of the bankruptcy or the anticipated distribution to unsecured creditors. See Vultures Beware at 924 and n.39. Its failure to disclose to the selling noteholders that it had access to inside financial information which could assist in evaluating the return to the sellers through the reorganization if they had held their notes, whether or not the information was used in CVC's purchase of claims, prohibited the sellers from accurately assessing the true market value of their claims or the loss or benefit to be derived from the sale. CVC's failure to disclose constituted a misuse or abuse of the bankruptcy process by an insider. See Joy Flowers Conti, Raymond F. Kozlowski, Jr., Leonard S. Ferleger, Claims Trafficking in Chapter 11 — Has the Pendulum Swung Too Far?, 9 BANKRUPTCY DEVELOPMENTS JOURNAL # 2, at 281, 299 (1992) (hereafter Claims Trafficking).

III. CVC is an Insider

The Bankruptcy Code defines an insider of a corporate debtor as including directors, officers of the debtor, persons in control of the debtor (and other entities not relevant to the issue herein). *11 U.S.C. § 101*(31)(B). Although there are numerous bankruptcy court decisions regarding the scope of the definition of "insider," few courts of appeals have passed on the question. Those which have addressed the issue agree that the definition's use of the word "includes" suggests an expansive interpretation of the term rather than a narrow one. See *Matter of Holloway, 955 F.2d 1008 (5th Cir. 1992); Matter of Newcomb, 744 F.2d 621, 625 n.4 (8th*

[10] Obtaining voting control and achieving a profit may not be objectionable under other fact patterns. Here, however, an insider placed itself in such a position without making the necessary disclosures and is not entitled to profit from its efforts.

*Cir. 1984); Matter of Missionary Baptist Foundation of America, Inc., 712 F.2d 206, 210 (5th Cir. 1983).* The broader view of the scope encompassed by the definition of insider is based on legislative history which teaches that an insider "is an entity or person with a 'sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.'" *Missionary Baptist, 712 F.2d at 210,* citing S.Rep. No. 95-989, 95th Cong., 2d Sess. See also *Matter of Holloway, 955 F.2d at 1010; Matter of Newcomb, 744 F.2d at 625, n.4.* What constitutes a "sufficiently close relationship with the debtor" is a question of fact. Cf., *Matter of Holloway, 955 F.2d at 1014* ("the determination of insider status is a question of fact").

We find that the undisputed facts[11] establish that CVC had a "sufficiently close relationship" with Debtor to place CVC within the statutory definition of insider.[12] Through

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[11] In its original answer to the Committee's Complaint CVC averred that the Committee's allegation of CVC's insider status was a conclusion of law. In its amended answer filed on December 23, 1991, CVC admitted its insider status, then denied it in its Response to First Request for Admissions filed on January 10, 1992. CVC again admitted its insider status in its Second Amended and Restated Answer to Complaint filed on May 18, 1992.

[12] Cases in which insider status has been attributed to those not specifically enumerated in § 101 include *In re Holloway, 955 F.2d 1008 (5th Cir. 1992)* (divorced spouses); *In re Tanner, 145 Bankr. 672 (Bankr. W.D. Wash. 1992)* (lovers); *In re Standard Stores, Inc., 124 Bankr. 318 (Bankr. C.D. Cal. 1991)* (corporate debtor's president's ex-brother-in-law); *In re O'Connell, 119 Bankr. 311 (Bankr. M.D. Fla. 1990)* (friend who made several informal loans to the debtor); *In re Ribcke, 64 Bankr. 663 (Bankr. D. Md. 1986)* (parents of debtor's deceased wife); *Matter of Montanino, 15 Bankr. 307 (Bankr. D.N.J. 1981)* (parents of debtor's live-in fiance). Financial power over the debtor may be insufficient in and of itself to make an entity an insider. In *In re Torcise, 146 Bankr. 303 (Bankr. S.D. Fla. 1992),* the court held that, in order for a bank or its officers to be insiders in a preference action, they must have "unreasonable control" over the debtor or the debtor must have become

its equity position in Amalgamated, Debtor's parent and affiliate as defined in *11 U.S.C. § 101*(2), CVC controlled, pre-petition, at least one seat on each of the boards of directors of Amalgamated, Debtor, and Debtor's principal subsidiaries. These seats were occupied by CVC's vice president, Muqaddam. Muqaddam Deposition at 17-18, 21. Muqaddam was CVC's representative on the board because Pennsylvania law requires that corporate directors be natural persons. 15 Pa. Cons. Stat. Ann. § 1722. Thus, CVC itself could not serve as a director and had to designate a natural person, i.e., Muqaddam, to act on its behalf. See *Commodity Futures Trading Comm'n. v. Weintraub, 471 U.S. 343, 105 S. Ct. 1986, 1991, 1995, 85 L. Ed. 2d 372 (1985)* (a corporation, as an inanimate object, empowers agents to act on its behalf). Muqaddam testified that his duties as an employee of CVC include investing on CVC's behalf. Muqaddam Deposition at 6. Other duties include serving on the boards of directors of other companies in which CVC holds investments. Muqaddam Deposition at 18-19. As a vice president of CVC, Muqaddam was responsible for acquiring and monitoring CVC's investment in Debtor and related entities. Muqaddam Deposition at 11-13, 153. See also id. at 6, 398-99

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the bank's alter ego or instrumentality. The instant action does not involve a preference. It involves an attempt to profiteer through a purchase at a deep discount, without disclosure. Cf. *In re Polk, 125 Bankr. 293 (Bankr. D. Colo. 1991)* (the degree of control as a factor in determining insider status). Whereas control, reasonable or otherwise, is not the only test of insider status, control may be one of many factors to consider in determining insider status. In this case CVC was a large shareholder in Debtor's parent and held seats on the boards of the parent, Debtor and Debtor's subsidiaries. Moreover, Muqaddam, its officer and one of Debtor's directors, was its instrumentality. Muqaddam testified in deposition that he acted for CVC's benefit and on its behalf. Muqaddam Deposition at 6, 11-12. See also Muqaddam Deposition at 398-99 (Muqaddam decided to object to confirmation of the BDK Plan because it restricted distribution to CVC). Through Muqaddam CVC achieved its insider status. Through Muqaddam CVC was a de facto director and therefore was in a position to and did exercise some control.

(Muqaddam objected to confirmation of the BDK plan because it restricted distribution to CVC). He acknowledged in his deposition that he served on Debtor's board on behalf of CVC (Muqaddam Deposition at 15) and that he acted as a director of Debtor to monitor CVC's investment. Id. at 20. Through Muqaddam's position on Debtor's board, CVC had access to financial information with respect to Debtor and its reorganization plans.

CVC argued at the hearing on the motion for partial summary judgment that the Committee had the same access "to management of the company" and to "the basic underlying facts." Notes of Testimony of June 24, 1992, at 41. However, it did not go so far as to contend that the Committee had equal access to the analyses of those facts or that the Committee was an entity sufficiently close to Debtor to be an insider. Id. Furthermore, CVC took part in various business decisions concerning Debtor, and was in a strategic and unique position regarding Debtor's re-structuring and reorganization. This is further evidenced by the fact that when certain objections of CVC to the BDK plan were not withdrawn,[13] the issue of whether the plan was confirmable as fair and equitable without CVC's consent was present.

To illustrate CVC's superior access to financial and business information and its control over Debtor, we set out some of the facts of record. Muqaddam, while on Debtor's board, approached CVC with the proposition that CVC purchase claims against Debtor. CVC then authorized the purchases and provided the funds. Muqaddam testified with respect to CVC's proposed purchase of the assets of subsidiaries, Knomark and Barth & Dreyfuss, that he relied

[13] These entailed CVC's desire for (1) a seat on the board of the reorganized company and (2) a change in the distribution language of the plan. When those goals were achieved, the remaining objections were withdrawn, and the BDK plan was confirmed on January 21, 1992.

on "information about the businesses and some financial information about these companies from . . . periods . . . prior to 1990", Muqaddam Deposition 270 at lines 17-21, including data gleaned from a visit to Barth & Dreyfuss, as well as from published sources. Muqaddam Deposition at 270. Muqaddam also had financial projections that had been "supplied to the creditors' committee or were developed for that purpose." Id. at 271, lines 6-7. Some aspects of those projections were supplied to the Bank of New York with which CVC was discussing financing arrangements for the asset purchase plan that CVC was attempting to put together. Id. at 271. Further, Muqaddam expected CVC's offer through the CVC Plan to be accepted by the Committee because the value was within the range developed by the adviser to the predebt restructuring debenture bondholders. Muqaddam Deposition at 345. Muqaddam acquired this information from Debtor's management.[14] Muqaddam also testified that the CVC plan of reorganization filed by Debtor was based on CVC's proposed asset purchase. Muqaddam Deposition at 449. In order to prepare the asset purchase offer Muqaddam requested and received from Debtor a financial analysis of Debtor prepared by the Committee's accountant. Muqaddam Deposition at 488-89.

Frank T. Kane, Debtor's former chief financial officer, testified that financial projections prepared by or for Debtor in connection with the bankruptcy were modified at the request of Muqaddam or a member of his staff with reference toward CVC's proposed asset purchase. Kane Deposition at 80-81 (hereafter "Kane Deposition"). Although the projections were a part of Debtor's records, they were never

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[14] Muqaddam said he "heard" the range from management and that it was "possible" that he actually had seen valuations prepared by the bondholders' adviser. Muqaddam Deposition at 345-46.

provided to Chanin & Company (the financial advisers to the Committee), to any member of the creditors' committee, or to its counsel. Kane Deposition at 81.[15]

Due to Muqaddam's unique position he was able to obtain financial information not otherwise available.

IV. Fiduciary Duty

Generally, a member of the board of directors holds a fiduciary duty "to promote the interests of the corporation." *United States v. Byrum, 408 U.S. 125, 138, 33 L. Ed. 2d 238, 92 S. Ct. 2382,* rehearing denied, *409 U.S. 898, 34 L. Ed. 2d 157, 93 S. Ct. 94 (1972).*

In general, officers and directors of a corporation are required to devote themselves to the affairs of the corporation with a view to promoting its interests rather than their own. They may not utilize their position in the corporation to obtain any personal profit or advantage beyond that enjoyed by its shareholders.

*In re Gailey, Inc., 119 Bankr. 504, 511 (Bankr. W.D. Pa. 1990).* Furthermore, it is a longstanding rule that "directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession." See *Commodity Futures Trading Comm'n v.*

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[15] Although projections were provided to the Committee, they apparently were not the same as those contained in the modifications provided to CVC. Kane Deposition at 80-88. CVC also requested, and was provided, projections of monthly working capital and income distribution but Kane was not sure if the numbers used were those based on CVC's assumptions or if the information was based on Debtor's projections. Id. at 85. However, Kane also testified that Muqaddam "or one of his representatives" had asked for "a monthly model for an income statement, balance sheet and cash flow to disclose to [CVC] the working capital changes and income statement movement within a prescribed period of time," id. at 87, with respect to the Barth & Dreyfuss subsidiary in order to determine that company's seasonal credit requirements. Id. at 88.

*Weintraub, 471 U.S. 343, 355, 85 L. Ed. 2d 372, 105 S. Ct. 1986 (1985).* See also *Wolf v. Weinstein, 372 U.S. 633, 649, 10 L. Ed. 2d 33, 83 S. Ct. 969,* rehearing denied, *373 U.S. 928, 10 L. Ed. 2d 427, 83 S. Ct. 1522 (1963).* Upon insolvency of the corporation, the director's fiduciary duty extends to the corporation's creditors and is enforceable by the trustee. See *Pepper v. Litton, 308 U.S. 295, 307, 84 L. Ed. 281, 60 S. Ct. 238 (1939); Brown v. Presbyterian Ministers Fund, 484 F.2d 998, 1005 (3d Cir. 1973).* The fiduciary duty of a director of a bankrupt corporation has sometimes been compared to that of a trustee. Neither a trustee nor a director may make a profit from the bankrupt corporation. See *Magruder v. Drury, 235 U.S. 106, 119-20, 59 L. Ed. 151, 35 S. Ct. 77 (1914).*

Under the circumstances described in this opinion, CVC was an insider which held the same fiduciary duty to Debtor as did Muqaddam, as though CVC were a de facto director of Debtor. Although directors may purchase claims against their corporation when the corporation is solvent, they are not entitled to do so at a discount and enforce the claims at full value when the corporation is insolvent or has filed bankruptcy. *In re Bridgford Co., 237 F.2d 182, 185 (9th Cir. 1956).* See also *Manufacturers Trust Co. v. Becker, 338 U.S. 304, 313-14, 94 L. Ed. 107, 70 S. Ct. 127 (1949), Monroe v. Scofield, 135 F.2d 725 (10th Cir. 1943), In re UVAS Farming Corp., 91 Bankr. 575, 577 (Bankr. D.N.M. 1988)* (when a director purchases claims against its corporation in bankruptcy, recovery is limited to the amount paid for the claims). This is not a situation where a Chinese wall was implemented with policies and procedures effective to prevent the misuse of nonpublic information, see *In re Federated Dept. Stores, Inc., 1991 WL 79143* (Bankr. S.D. Ohio, March 7, 1991), nor does it have any of the earmarks

of an arm's length transaction. The bankruptcy court is not required to treat these claims equally with those of other creditors.[16] See *Pepper v. Litton, 308 U.S. at 306-07.*

Although Muqaddam was a director of Debtor, he acted on behalf of CVC, of which he was an officer, in its best interests and with its express approval. Muqaddam adhered to CVC's directives rather than to his fiduciary obligation to act in the best interests of Debtor and Debtor's estate. In so doing, his actions as a director of Debtor were taken with improper motive; that is, to benefit CVC, not to serve Debtor or its creditors. Through Muqaddam, CVC was able to obtain a blocking position with respect to the plan of reorganization which it then attempted to use in its own self-interest, to its advantage by the proposal of a plan different from the BDK plan.

Furthermore, the availability of claims for purchase at a discount pursuant to a bankruptcy constitutes a corporate opportunity. *Brown v. Presbyterian Ministers Fund, 484 F.2d at 1004,* citing *Weissman v. Weissman, Inc., 374 Pa. 470, 97 A.2d 870 (1953).* Outside of bankruptcy, if the corporation is unable to use the corporate opportunity, a director may do so if the director discloses to shareholders, the shareholders consent and the use of the corporate opportunity by the director is not detrimental to the corporation. *CST, Inc. v. Mark, 360 Pa. Super. 303, 520 A.2d 469, 471* (Pa. Super.), appeal denied, *539 A.2d 811 (Pa. 1987).* See also *Robinson*

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[16] At the hearing on the instant motion, counsel for CVC referred to *In re Marin Town Center, 142 Bankr. 374 (N.D. Cal. 1992).* The case concerned allowance of a vote on a plan in the context of good and bad faith in purchasing claims. However, there is no indication in the reported decision that the entity which acquired its creditor status by postpetition claims purchases was an insider or a fiduciary of the debtor. Moreover, CVC did not vote on a plan in this case. The case is not apposite to the situation before us.

*v. Brier, 412 Pa. 255, 194 A.2d 204, 206-08 (Pa. 1963).* CVC disclosed nothing and failed to obtain the consent of Debtor's shareholder to the purchase.

Even when purchasing claims against a solvent corporation, a director has a heavy burden to establish the fairness of the conduct. *Robinson v. Brier, 194 A.2d at 206.* Appropriation of corporate opportunities by a fiduciary of an insolvent entity, even with approval of the shareholders, directors, and officers, is impermissible when it results in a detriment to creditors. *Brown v. Presbyterian Ministers Fund, 484 F.2d at 1005.* Detriment is a relative term. In this case, at least two detriments are identifiable. The first befell the selling noteholders who, at the time of sale, were creditors of Debtor and were deprived of the ability to make an informed decision concerning the sale of their claims. If, after full disclosure, they had elected not to sell they would have received a total distribution of $15,989,676.56 rather than the amount paid by CVC of $10,553,541.88, a difference of more than $5.4 million. If they elected to sell at CVC's price after full disclosure, the harm attendant to them as the result of CVC's nondisclosure would not exist. See *Wolf v. Weinstein, 372 U.S. 633, 10 L. Ed. 2d 33, 83 S. Ct. 969 (1963).* Even were there no harm to the selling noteholders, however, the other creditors were harmed. Debtor negotiated the BDK Plan with its creditors before it filed bankruptcy. CVC was not a prepetition creditor but it acquired enough claims postpetition to control the outcome of a plan and to induce Debtor to propound the "CVC Plan" which competed with Debtor's proposed BDK plan. The CVC plan would have turned over to CVC, through a purchase by a company to be formed by CVC, all of the valuable assets of Debtor. CVC's actions diluted the voting rights of the prepetition creditors by enabling CVC to acquire voting control from several entities, any of which, alone, may have been unable to control the class. This detriment was minimized by CVC's decision not to vote its claim,

but creditors nonetheless were forced to incur costs and fees to investigate and challenge CVC's actions and their effects on the class of unsecured claims and seek relief through negotiation or court order — none of which would have been necessary had appropriate and timely disclosures been made. Thus, having failed to meet the first two requirements regarding the use of corporate opportunity, CVC similarly failed to meet the third.

V. Respondeat Superior

As a matter of law, Muqaddam was CVC's agent and, under the doctrine of respondeat superior, CVC is liable for Muqaddam's breach of fiduciary duty. See § IV, Fiduciary Duty, supra. CVC "knowingly permitted its agent", Muqaddam, to purchase claims against Debtor, authorized his actions and provided him with the authority and the means to accomplish the purchase. *Moss v. Elan Memorial Park Corp., 400 Pa. Super. 555, 583 A.2d 1254, 1257 (Pa. Super. 1990).* CVC, with knowledge of Muqaddam's dual role, expressly granted to Muqaddam the power and funds with which to purchase the claims and so is bound by Muqaddam's actions. See *Lokay v. Lehigh Valley Co-op. Farmers, Inc., 342 Pa. Super. 89, 492 A.2d 405, 409 (Pa. Super. 1985).* Muqaddam was acting within the scope of his employment with CVC in purchasing the claims and his conduct was in furtherance of CVC's business inasmuch as he was charged with the responsibility of monitoring CVC's investments and ensuring their performance. Pennsylvania law dictates that under these circumstances CVC is liable for Muqaddam's conduct. See *Johnson v. Glenn Sand and Gravel, 308 Pa. Super. 22, 453 A.2d 1048, 1050 (Pa. Super. 1982)* (tort liability). In fact, CVC's liability would exist even if Muqaddam was only partially motivated by a desire to serve CVC's interests. *Shuman Estate v. Weber, 276 Pa. Super. 209, 419 A.2d 169, 173 (Pa. Super. 1980).*

VI. Disclosure

Case law under the former Bankruptcy Act warns against the dangers of trading in postpetition claims. Those dangers are present in Bankruptcy Code cases as well. In Wolf v. Weinstein, the United States Supreme Court articulated some concerns regarding trading in claims by insiders of an insolvent corporation:

> Access to inside information or strategic position in a corporate reorganization renders the temptation to profit by trading in the Debtor's stock particularly pernicious. The particular dangers may take two forms: On the one hand, an insider is in a position to conceal from other stockholders vital information concerning the Debtor's financial condition or prospects, which may affect the value of its securities, until after he has reaped a private profit from the use of that information. On the other hand, one who exercises control over a reorganization holds a post which might tempt him to affect or influence corporate policies — even the shaping of the very plan of reorganization — for the benefit of his own security holdings but to the detriment of the Debtor's interests and those of its creditors and other interested groups.

*Wolf v. Weinstein, 372 U.S. at 642.* Cf. *Pepper v. Litton, 308 U.S. at 307* (fiduciary obligation exists to protect creditors as well as stockholders). More recently one commentator stated that

> This lack of disclosure has two effects. First, it is detrimental to the efficiency of the market for claims. An efficient market requires that both the buyer and the seller have access to information so that each party to the transaction can be adequately informed. Under Bankruptcy Rule 3001(e), as amended, large sophisticated purchasers of claims, who have the resources

> and incentives to closely monitor a chapter 11 case, have more information regarding the value of a claim than a small trade creditor, and the small trade creditor has no reasonable means to acquire that information. Second, because only the name of the transferee of record need be disclosed, parties in interest will be unable to ascertain who the real claims buyer is and the intentions of that claims buyer with respect to the control of a debtor.

Claims Trafficking, *9 BANKR. DEV. J. at 300* (footnotes omitted). The fact that CVC cannot physically maintain a seat on Debtor's board and must designate a natural person to fill its position, under the facts of this case, does not eradicate the dangers articulated in Wolf v. Weinstein and the Claims Trafficking article.

The filing of a bankruptcy creates a private market in securities and, without disclosure, creditors are at risk of selling claims "at extraordinary discounts, without understanding their rights". *In re Allegheny Int'l., Inc., 100 Bankr. 241, 242 (Bankr.W.D.Pa. 1988)* (footnote omitted). Muqaddam stated that "normal market protocol" does not require disclosure of the identity of a buyer when claims are purchased through a broker. Muqaddam Deposition at 165-66, 176, 219-20. However, normal market protocol is not necessarily the applicable standard in a bankruptcy context where disclosure is a fundamental precept. Cf. *Commodity Futures Trading Comm'n. v. Weintraub, 471 U.S. at 357* ("by definition, corporations in bankruptcy are treated differently from solvent corporations").

Much of the Bankruptcy Code is premised on disclosure.[17] For example, a debtor must disclose all of its assets and liabilities, regardless of their contingent or unmatured nature, *11 U.S.C. § § 521,* 101(5),(12), Fed. R. Bankr. P. 1007. A proof of claim filed by a creditor must identify the nature of the claim and supporting documentation must be attached if it exists. *11 U.S.C. § § 501,* 502, Fed. R. Bankr. P. 3001. A plan of reorganization cannot be confirmed without court approval of a disclosure statement containing "adequate information", *11 U.S.C. § 1125,* according to the nature of the case and its creditors. In a bankruptcy context, the purchase of claims through or by an insider must be governed by rules which differ from "normal market protocol." It cannot be gainsaid that the selling noteholders' price demands may have been affected by the knowledge that the purchaser had access to inside information concerning the financial affairs of Debtor, its parent and its subsidiaries and that the purchaser could use such information in offering its bid price.[18]

This situation has none of the earmarks of an arm's length transaction and CVC's failure to disclose its identity and connection with Debtor was inherently unfair to the selling noteholders as well as to the shareholder, which should have had the first opportunity to take advantage of a corporate opportunity, whether or not it had the resources to do so. The Committee and Debtor were entitled to know

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[17] "Disclosure is fundamental in a bankruptcy case." Claims Trafficking, *9 BANKR. DEV. J. at 302.* "The interest of sellers in having adequate information available for them to make an informed decision and the interest of nonsellers who may find themselves controlled by a third party whose intent would be to minimize the value that goes to the nonsellers are the two interests that need to be protected in control contests." *Id. at 304.*

[18] Whether or not such use actually existed or access to information actually provided the buyer with an advantage via superior knowledge is not dispositive.

at least the quantity and dollar value of the claims being purchased by CVC, particularly because CVC and Debtor were negotiating with respect to the purchase of Barth & Dreyfuss and Knomark, two subsidiaries of Debtor, as part of Debtor's proposed reorganization plans. Here, Muqaddam, an insider with a fiduciary duty to Debtor was the conduit through which his employer (CVC - a company in which Muqaddam is an officer and which had acquisition designs on Debtor's subsidiaries) purchased claims with absolutely no disclosure to the entities whose interests were affected by these actions.

Cases decided under the Bankruptcy Code express the necessity for the bankruptcy court to exercise its equitable powers and "sift the circumstances surrounding any claim to ensure that injustice or unfairness to creditors does not occur in administration of the bankrupt estate." *In re Allegheny Int'l., Inc., 118 Bankr. 282, 302 (Bankr. W.D. Pa. 1990),* citing *Pepper v. Litton, 308 U.S. at 307-08.* See also *In re Allegheny Int'l., Inc., 100 Bankr. 241 (Bankr. W.D. Pa. 1988); Matter of Executive Office Centers, Inc., 96 Bankr. 642, 649-50 (Bankr. E.D. La. 1988); In re UVAS Farming Corp., 91 Bankr. 575 (Bankr. D.N.M. 1988).* In this case the lack of disclosure created an unfairness in that prepetition noteholders sold their claims in a transaction that was not at arm's length and was not on a "level playing field". The resulting sale was accomplished without the knowledge of sellers of the insider status of the buyer and without benefit to the sellers of access to inside information available to the buyer concerning the estimation of dividends the claim holders could anticipate through a plan — information available to all of Debtor's directors, including Muqaddam.

CVC argues that it should not be penalized because a member of the Committee, Magten Asset Management Corporation, also purchased claims. Magten, however, was not a director. It was Debtor's third largest prepetition creditor

and the postpetition claims it purchased accounted for only three per cent of its total investment in Debtor. See Stipulation and Order Compromising and Settling Claims, Motion No. 91-9157(B) at Exhibit A. Moreover, Magten disclosed to the sellers its identity and connection with Debtor. Magten settled the causes of action brought against it for claims trading by agreeing to limit its recovery to the amount it paid for the claims, although the settlement included the allowance of the claims at their face value. See Stipulation and Order Compromising and Settling Claims, Motion No. 91-9157(b), at *9 P. 2.*[19] Furthermore Magten's purchases were on behalf of its customers, not for its own account. At its customers' direction, Magten also sold claims it held for the benefit of its customers, again disclosing its identity and connection with Debtor to the ultimate purchasers. If CVC had not breached its duties by failing to disclose its activities and the extent thereof to Debtor and the Committee, and its identity and connections with Debtor to the sellers, a different result may have obtained.[20]

VII. Allowance of the Claim

We now must determine the allowed amount of CVC's claim and the appropriate measure of payment under the plan. The Committee seeks to limit the amount of the claim to what CVC paid for the claims. There are many possible alternatives but three have been argued: (1) allowance of the claims at full face value of the notes purchased; (2) allowance of the claims limited to their actual cost to CVC;

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[19] *11 U.S.C. § 1123*(a)(4) requires that a plan of reorganization "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment. . . ."

[20] The argument that this court cannot deal with this issue pursuant to Federal R. Bankr. P. 3001(e) is without merit. Even as amended in 1991, the bankruptcy court has the power under the Rule to adjudicate disputes regarding claims transfers.

or (3) allowance of the claims at full face value of the notes purchased but limitation of recovery under the plan to actual cost with or without interest. For the reasons discussed below, we hold that the claim is allowed at face value but CVC's recovery is limited to the amount it paid for the claims, without interest. We agree with those cases that hold that insiders cannot purchase claims from a corporation in bankruptcy and enforce the claims at their full value. See, e.g., *In re Bridgford Co., 237 F.2d 182, 185 (9th Cir. 1956)*, cert. denied, *352 U.S. 1005, 1 L. Ed. 2d 550, 77 S. Ct. 566 (1957); Monroe v. Scofield, 135 F.2d 725, 728 (10th Cir. 1943); In re UVAS Farming Corp., 91 Bankr. 575, 577 (Bankr. D.N.M. 1988)*. This limitation removes the unfair advantage to be gained through undisclosed insider status and access to or use of inside information and protects the voting rights of the affected class of creditors. By eliminating the profit, a disincentive to "vulture trading" is established. CVC purchased its claims at a time when it could evaluate the risk of its acquisition to its advantage. It is an improper use of the bankruptcy process for an insider to gain profits from its undisclosed superior access to information whether or not it took advantage of that access, particularly when it is at the expense of prepetition creditors/sellers. By reducing the value of CVC's claim to its actual cost of purchasing the claim, CVC will bear the consequences of its failure to disclose. By limiting the return on CVC's claims there will be an additional distribution to all general unsecured creditors under the plan.

CVC suggests that if its distribution is to be limited, the distribution should not be less than the amount it paid, plus interest. Its argument is that the Bankruptcy Code and the Bankruptcy Act do not provide for damages against an insider who purchases claims of a bankrupt. This argument misses the point. Payment to CVC of the full amount of its allowed, unsecured claim when other unsecured creditors are receiving less is not in accord with the

distribution provisions of the Bankruptcy Code. The amount of CVC's recovery will be governed by the distribution provided to the applicable class under the confirmed plan of reorganization, based upon the allowed amount of its claim but capped at CVC's cost of $10,553,541.88. The limitation of the distribution is not a damage award to any other party. It is a determination of Debtor's liability to CVC. Furthermore, CVC is not entitled to payment of interest. No other creditors in CVC's class will receive interest under the plan and there is no basis for providing special treatment to CVC's claim. Indeed, to do so would violate § 1123(a)(4) of the Bankruptcy Code which prohibits disparate treatment among class members.[21] Cf. *United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989)* (interest allowed on oversecured claims if certain conditions exist). Furthermore, limiting CVC's distribution will create a disincentive to engage in similar behavior by others in the future when the transaction is not at arm's length and is brought about by or involves insiders who fail to make sufficient disclosure to the appropriate parties.

VIII. Conclusion

The parties argue for and against the existence and/or application of a per se rule which limits the allowance of claims purchased postpetition in circumstances such as those at bench. It may be that nondisclosure will not subject an insider who purchases claims to censure in some situations.

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[21] Section 1123(a)(4) of the Bankruptcy Code provides: "(a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall — (4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." CVC's request to have interest added to its allowed claim would give it preferential treatment, not the "less favorable treatment" authorized, upon consent, by the statute because no other creditor in CVC's class will be paid interest.

See, e.g., *In re Federated Dept. Stores, Inc., 1991 WL 79143* (Bankr. S.D. Ohio, March 7, 1991) (procedures to safeguard various interests). Therefore, we do not grant partial summary judgment on the basis of a per se rule as the Committee asks. However, we find that no material disputed facts exist and, as a matter of law, CVC is an insider whose breach of fiduciary duty, failure to disclose, and self-dealing compel the limitation imposed herein on the distribution to be made on its allowed claim.

The issue of equitable subordination raised in the complaint is not before the court on this motion for partial summary judgment. Therefore, an order will be issued scheduling a conference on that issue.

An appropriate Order will be entered.

Judith K. Fitzgerald, United States Bankruptcy Judge

DATED: APRIL 22, 1994

**ORDER**

And now, to-wit, this **22nd** day of **April, 1994,** for the reasons set forth in the foregoing Memorandum Opinion, it is **ORDERED, ADJUDGED AND DECREED** that the motion of the Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims, as Estate Representative of Papercraft Corporation, Plaintiffs, seeking partial summary judgment is **GRANTED.** CVC's claim is allowed as a general unsecured claim in the amount of $60,849,299.10. However, CVC's distribution pursuant to the confirmed plan of reorganization is limited to its cost to purchase the claims, i.e., $10,553,541.88. The $60,849,299.10 represents $34,725,575.72 in First Priority Notes and $26,123,723.38 in Second Priority Notes.

A status conference will be held on **April 25, 1994,** at **1:00 p.m.** as previously ordered.

Judith K. Fitzgerald, United States Bankruptcy Judge